

SECTION I—INTRODUCTION

1. The independent Review Board for Government Contracts was established on 1st August, 1969 by an Agreement between the Government and the Confederation of British Industry (C.B.I.). The text of the Memorandum of Agreement is set out in Appendix A. We were appointed members of the Board by H.M. Treasury in agreement with the C.B.I.
2. By the Agreement our first task is to carry out an Interim Review in which we are asked to report, within a year of being established, on the new Profit Formula for non-competitive Government contracts, which came into force on 26th February, 1968. The basic issue to be determined in this Report is whether this Formula is a fair interpretation of the agreed 14 per cent target rate of return on capital employed. A paper entitled "Profit Formula Review—Arrangements agreed with Industry to be applied from 26th February, 1968", which explains the new Profit Formula, is set out in Appendix B.

3. The terms of reference for the Interim Review are set out in the Annex to the Memorandum of Agreement. The Interim Review has subsequently been extended by agreement between the Government and the C.B.I. for a further year to permit more detailed consideration of certain subjects, and we set out in Appendix C an extract from a letter dated 22nd June, 1970 from H.M. Treasury authorising this extension. We are asked to report on the following matters as part of the Interim Review:—

- (a) whether a change is needed in the average ratio of cost of production to capital employed of $1\frac{1}{2} : 1$ which has been agreed as the basis for calculating the new Profit Formula;
- (b) whether certain costs which are at present not accepted as charges to Government contracts should in future be so accepted, and whether the allowances for depreciation included in costs should be based on the charges made by contractors in their accounts instead of by reference to Inland Revenue rates;
- (c) whether any, and if so what, change should be made in the treatment of (i) investment grants for the purposes of assessing the capital employed by Government contractors and (ii) investment grants and other selective incentives for the purposes of overheads;
- (d) whether the remaining differences between the Government's accounting conventions and those used by industry require adjustments in the profit rates to achieve the agreed target."

4. We approached first items (b) and (c) in the list in paragraph 3, which involve a review of the Government Accounting Conventions used in pricing non-competitive Government contracts (the Conventions), in so far as they relate to attributable costs and investment grants and other selective incentives. We have also reviewed the Conventions relating to capital employed because these also are important to the basic issue whether the new Profit Formula is a fair interpretation of the agreed 14 per cent target rate of return on capital employed. Our comments on the Conventions relating to attributable costs, investment grants and other selective incentives and capital employed are contained in Sections II, III, IV and V of this Report.

We then considered items (a) and (d) which are concerned with the average ratio of cost of production to capital employed (CP/CE ratio) and the profit rates in the Profit Formula, since decisions on these subjects could not be taken until we had decided what changes were required in the Conventions. We deal with the Profit Formula in Section VI. Our conclusions regarding changes in the Conventions and the Profit Formula are summarised in Section VII.

5. In accordance with the Agreement, we have not concerned ourselves with the basic structure of the Profit Formula or with the level of the agreed 14 per cent target rate. These subjects will be for consideration in our General Review which is described in paragraphs 24 to 27 of the Memorandum of Agreement.

6. At the commencement of the Interim Review, we asked contractors to make representations to us on the subject of the Conventions; we wrote to 420 companies whose names were supplied to us by the Ministry of Technology and the Ministry of Defence as having undertaken a significant volume of non-competitive Government contracts in the past, and to 30 trade associations identified by the C.B.I. as representing companies interested in Government contracts. We also placed announcements in the Financial Times and the Board of Trade Journal on 10th November and 12th November, 1969, respectively. We received representations from 14 companies and 13 trade associations whose names are listed in Appendix D. Five trade associations with major interests in Government contracts: The Society of British Aerospace Companies, Ltd., the Electronic Engineering Association, The Society of Motor Manufacturers and Traders Limited, the British Electrical and Allied Manufacturers' Association Limited and the Telecommunication Engineering & Manufacturing Association Limited, together with the C.B.I., formed the Joint Review Board Advisory Committee (J.R.B.A.C.) for the purpose of making collective representations. The written evidence from industry was made available to Government Departments, and written evidence from the Departments was similarly made available to industry. Representatives of Government Departments and the J.R.B.A.C. also gave oral evidence at our invitation.

7. We have also considered the Report, dated September, 1968, of the Working Party on Overhead Costs set up by the Government and industry. An extract from this Report is set out in Appendix E.

8. We have had discussions with Government Departments and the J.R.B.A.C. concerning the average CP/CE ratio and the Profit Formula and we have had access to information supplied by the principal purchasing Departments.

9. We have given very careful consideration to all the evidence given to us by companies, trade associations and Government Departments. In this Report we refer only to those parts of the evidence which are necessary to explain our conclusions.

SECTION II—THE GOVERNMENT ACCOUNTING CONVENTIONS : GENERAL OBSERVATIONS

10. A formal statement of the Conventions was first given in a note attached to the Memorandum of Agreement (this is not included in Appendix A of this Report). A more complete summary of the Conventions was included in the Government submission to us dated 6th January, 1970, and this submission is set out in full in Appendix F to this Report.

11. One important question with which we have been concerned throughout the Interim Review is whether it is practicable and desirable to define the Conventions in greater detail for the use of purchasing Departments and contractors, as has been suggested by the J.R.B.A.C. The Government representatives pointed out that the application of the Conventions and their effect on individual contracts are a matter for discussion and negotiation between the purchasing Department and the contractor.

12. While it may not be possible to lay down fixed and detailed rules applicable in all circumstances, a formal statement of the Conventions has only recently been made available to contractors and in our view it is inevitable that there will be a need for further amplification. On the other hand the production of a more detailed statement of the Conventions depends in many cases on there being greater uniformity amongst contractors in the definition and classification of costs. We therefore welcome the arrangements, which we mention in paragraphs 25 and 30 and which have been agreed between the Government and the C.B.I., for further study of the Conventions relating to marketing and selling expenses and research and development expenditure, and we believe that any future problems arising in the application of the Conventions should be discussed between the Government Departments and industry.

SECTION III—THE GOVERNMENT ACCOUNTING CONVENTIONS : ATTRIBUTABLE COSTS

Depreciation Rates

13. The present Convention is to substitute for the contractor's own depreciation charge the allowances computed for Inland Revenue purposes. We were informed that this is done in order to provide some degree of uniformity of treatment between Government contractors and to avoid arbitrary decisions. This practice is departed from where the strict use of Inland Revenue rates would produce anomalous results as, for example, in the cases of scientific research allowances and "free" depreciation.

14. Many contractors have contended that the attributable costs should be based on the contractor's own depreciation rates instead of the Inland Revenue rates. They have stressed that there would be administrative advantages in using the same rates ; it would eliminate the need for complex computations and adjustments and would facilitate the comparison of costs produced from internal accounting systems with estimates and costs for Government contract purposes.

15. The Government representatives have told us that they also recognise the administrative advantages of adopting a contractor's methods of amortising the original cost of fixed assets and would be prepared to do so provided that these methods are consistent and result in a fair and reasonable charge for depreciation to be included in overheads. In our view, the contractor's own depreciation rates should be accepted for the purposes of attributable costs, provided that they are consistent and reasonable. However, the depreciation charge included should not be affected by the treatment of investment grants in the contractor's accounts and we deal with this subject specifically in paragraphs 48 to 52.

16. There will be some transitional problems in this change ; part of the cost of existing assets will have been included as a charge against Government contracts, amortised at the Inland Revenue rates, and to include the contractor's own depreciation charges as an attributable cost in future might result in the contractor recovering more or less than the whole cost of the asset by way of depreciation charges over its life. We consider that the difference between the total written down value for Government contract pricing purposes and the net book value of existing assets should be eliminated by an adjustment to the company's depreciation charge over a future period in accordance with a plan agreed between the contractor and the Department.

Allowance for Increased Replacement Costs

17. The Conventions provide for amortisation of the original cost of fixed assets with no allowance for the increased costs of replacement. Many contractors have contended that if a company carries out a bona fide revaluation of fixed assets and incorporates the figures in its accounts, the resultant figures for fixed assets and depreciation should be acceptable for all accounting purposes. To do otherwise, it is contended, is inequitable for capital intensive industries.

18. The Government representatives informed us that in their view there would be considerable practical difficulties involved in such a change, given the varying practices at present adopted by contractors and the lack of any clear guidance from the professional accountancy bodies. They thought, furthermore, that a change might have undesirable implications going far beyond the immediate effect on non-competitive Government contracts.

19. This subject is closely related to that of the target rate of return in the Profit Formula; the agreed 14 per cent target rate is an average of the actual results of about 1,500 companies calculated on the basis of the historic cost of fixed assets and the rate would have been significantly lower if replacement costs had been taken into account. Our terms of reference for the Interim Review require us to decide whether the Formula is a fair interpretation of the agreed 14 per cent target rate, and in the General Review we will be considering the wider question of what is an appropriate rate of return. We do not, therefore, propose any change in this Convention.

Marketing and Selling Expenses

20. The present Convention is that marketing and selling expenses may be partially excluded from attributable costs; certain items, such as discounts allowed and bad debts, are normally totally excluded from attributable costs. The Government have given an explanation of their treatment of these expenses in paragraph 8B of their submission dated 6th January, 1970 (Appendix F).

21. This subject has provoked a large volume of comment from contractors who contend that marketing and selling expenses should be apportioned pro rata to all contracts, Government and civil, since the Government benefit by the reduced level of general overheads by virtue of the additional work-load obtained through marketing activities in the non-Government field.

22. In our view, some costs which are commonly classed as marketing costs should be charged direct to particular contracts, either because they are incurred in the performance of a contract or because they are otherwise identified with a specific contract. These include:—

Bad debts.

Discounts allowed on sales.

Insurance (of credit and goods in transit).

Agents' commissions.

After sales service costs—where attributable to a specific product.

Outward carriage of finished products.

As these costs will either not arise or will be met by the Government on their contracts, we endorse the current Convention that they should normally be excluded from attributable costs.

23. Salesmen's commissions are also excluded under the current Convention. These are, in most cases, a normal form of remuneration for salesmen and we consider that they should generally not be treated as direct costs but as part of salesmen's salaries.

24. We have had great difficulty in reaching firm conclusions regarding marketing and selling overhead costs as we have been unable to identify sufficiently clear principles underlying the current treatment of these costs. We asked for facts about the results of the current treatment and received information from 22 companies, which has been useful to us in giving a

general impression of the results of the present policy. It is not possible, however, to make a satisfactory summary of the results, owing to different definitions of what is embraced by marketing costs, and to the fact that pricing negotiations with Government Departments cannot always be conducted in such a way as to identify precisely which costs are allowed and which are disallowed.

25. We are not convinced, on the evidence that we have seen, that the treatment of marketing and selling overhead costs in pricing non-competitive Government contracts has, in the aggregate, been unreasonable. We are concerned, however, that there should be clearer principles to determine the admissibility of costs, so as to avoid inconsistencies in treatment and confusion and time-wasting in price negotiations. The Government and the C.B.I. have agreed that the Interim Review should be extended for up to a further year so that we may endeavour, in consultation with Departments and contractors, to find a more satisfactory way of attributing marketing and selling overhead costs to Government contracts. We do not intend to affect materially the aggregate amount of these costs included under the present Convention.

Entertainment Expenses

26. The Government statement of the current Conventions lays down that entertainment expenses may be partially excluded and this item has also provoked several submissions from contractors and trade associations. Entertainment is usually concerned with marketing and in our view entertainment costs cannot be dissociated from other marketing costs. We do not, therefore, intend to make any decision concerning the treatment of this item in isolation but we will consider it with other marketing and selling overhead costs in the further review mentioned in paragraph 25 above.

Research and Development Expenditure

27. The present treatment of research and development expenditure in pricing non-competitive Government contracts is described in paragraph 8C of the Government submission dated 6th January, 1970 (Appendix F). It is, broadly, to accept for inclusion in overheads attributable to non-competitive contracts all reasonable expenditure on basic research ; to exclude all expenditure incurred for exclusively commercial projects ; and to recognise that the area of remaining expenditure (termed the "grey" area) calls for individual judgment on the degree of admissibility to overheads for Government work.

28. Neither the Government representatives nor the contractors have suggested any major changes in the present practice, but both sides are concerned to reduce the uncertainty in the "grey" area by improving the methods of identifying and accounting for research and development costs to specific products.

29. The Working Party on Overhead Costs considered this problem and proposed a classification of expenditure and principles for the recovery of costs. They also suggested that there should be discussions between Government Departments and contractors within their proposed general guide lines. They hoped that in this way it would be possible to formulate principles and methods of operation which would be acceptable as fair and reasonable by both parties. The Working Party's approach is given in paragraphs 5.6.7 to 5.6.10 of their Report, which are set out in Appendix E.

30. We endorse the approach of the Working Party and suggest that discussions along the lines recommended by the Working Party should commence as soon as possible. The Government and the C.B.I. have agreed that we should hold ourselves available to give a decision on any point referred to us within the Working Party's principles.

Employees' Profit Sharing Schemes

31. According to the current Convention, payments under employees' profit sharing schemes are normally totally excluded from attributable costs. Several contractors have submitted that this is unrealistic, because it is common in industry for certain employees to be remunerated partly by a basic salary and partly by a percentage of profits. Such schemes are, it is contended, merely a method of arriving at employees' total remuneration, the whole of which should be included in attributable costs.

32. We agree with the contractors that where payments under employees' profit sharing schemes are simply an element in employees' normal remuneration the payments should be included in attributable costs. In some cases, however, such schemes are more of the nature of a distribution of profits and the payments should be excluded. The Government representatives suggested that a suitable test to determine the true nature of a scheme might be whether the payments were accepted by the Inland Revenue as charges against the company's profits for tax purposes, and we consider that this would be a fair basis on which to treat these costs.

Stock Losses and Obsolescence

33. Under the current Convention, an allowance is normally made in the direct costs of a Government contract for the cost of rejects and scrap arising on the contract in question and, where appropriate, for any materials which may be unused as a result of changes in specifications and for losses due to cancellations. In special cases there may be an additional charge, for example when general stock which is drawn upon for Government contracts becomes obsolete as a result of rapid technological changes.

34. The J.R.B.A.C. have said that in order to fulfil Government contracts it is always necessary to draw upon the contractor's general stock of raw materials and components, on which losses or obsolescence arise, and, if delivery dates are to be met, specific materials often have to be ordered further ahead than Government Departments are willing to authorise. They contend that a certain level of stock losses is a normal and accepted part of the costs of keeping any such stocks and mainly arises from issues which for various reasons are not accounted for, together with a certain amount of pilferage and undocumented damage; in addition, obsolescence arises by reason of multiplicity of technical changes. The J.R.B.A.C. submit, therefore, that the costing procedures should conform to the facts and that, as regards general stocks and components, overheads should include stock losses and the costs of obsolescence which should be apportioned over Government and non-Government work in the normal way.

35. We consider that both Government contracts and other contracts should bear as a direct charge the cost of all stock losses and obsolescence, including provisions, arising therefrom; other general stock losses, including provisions, should be included in overhead costs attributable to both Government and other work. Under this approach, the company's costing system must provide for the isolation of those stock losses which are directly attributable to civil

contracts as well as those that are attributable to Government contracts. We do not know whether the adoption of this principle as we have stated it above would result in any significant change in the present practice of purchasing Departments, but we consider that the principle should be included in the Conventions.

Directors' Remuneration

36. One contractor has said to us that it is unreasonable for there to be a restriction on the total amount of directors' remuneration which may be charged as an overhead for Government contract purposes. The Government representatives have told us that directors' remuneration is always included in attributable costs except where the amounts paid are judged to be out of all proportion to the management services rendered.

37. We consider that there should be no arbitrary restriction on the amount of directors' remuneration but that Government Departments should continue to exclude remuneration which is considered unreasonable, provided full explanations are given to the contractor.

Redundancy Payments

38. Under the current Convention, redundancy payments in excess of the rates prescribed by Statute may be partially excluded. The J.R.B.A.C. have contended that contractors are sometimes compelled for various reasons to make redundancy payments in excess of rates laid down by Statute and that these are expenses which the contractors would not incur unless it was necessary to do so in the interests of their business; the whole of the expenditure should accordingly be included in attributable costs. The Government representatives have told us that purchasing Departments adopt a reasonable approach to this item and admit excess payments where there are special grounds for doing so.

39. We consider that reasonable redundancy payments in excess of the rates laid down by Statute, made under the terms of a bona fide scheme, should be included in attributable costs.

Subscriptions and Donations

40. The Government statement of the Conventions lays down that subscriptions and donations are normally totally excluded from attributable costs, except for reasonable contributions to institutions from which benefits accrue to the contractor or his employees. The J.R.B.A.C. and some trade associations have argued that this is too restrictive since every company is obliged to make donations and does not do so unless there will be some benefit to the business as a result. It has been said, furthermore, that the present practice results in a time wasting analysis of these items.

41. We consider that subscriptions to trade and other institutions from which benefits accrue to the business should be included in attributable costs; subscriptions to most charities and to all political organisations should be excluded. This treatment is similar to that adopted by the Inland Revenue for tax purposes and we consider that items accepted by the Inland Revenue should be included for Government contract purposes.

Loss of Profits Insurance Premiums

42. Under the present Convention, the profit element of a loss of profits insurance premium is normally excluded from attributable costs and any

receipt in respect of loss of profits is not deducted. Some contractors have challenged this on the grounds that the premium is a normal business expense and should not therefore be excluded. We accept the present Convention as reasonable.

Unnecessary, Extravagant and Wasteful Expenditure

43. The Government statement of the Conventions says that unnecessary, extravagant and wasteful outlays are normally totally excluded from attributable costs. It has been contended by the J.R.B.A.C. and others that this rule is too vague since the issue is largely a matter of opinion based upon comparative data the validity of which the contractor has no opportunity to disprove; they suggest that if a purchasing Department seeks to exclude a cost on these grounds it should be necessary to establish the clearest possible reasons for doing so, and the contractor, if necessary through an independent investigation, should have access to the facts and data on which the proposed exclusion is based. The Departments accept that the contractor is entitled to a full explanation of any proposed exclusion but do not accept the need for an independent investigation of one particular item involved in pricing contract.

44. We have seen no evidence to lead us to believe that Departments have been unreasonable in this respect. We do not accept industry's view that an independent investigation should be available but we do consider that the contractor should be entitled to a full explanation of the reasons for any exclusion. We consider that in cases where only a small proportion of the contractor's turnover is made up of non-competitive Government contracts, there should be a presumption that all expenses were reasonably incurred.

The Definition of Costs for the purpose of calculating the Cost of Production of the business as a whole

45. A number of items of expense which are normally considered inadmissible as attributable costs of Government contracts are nevertheless admissible for inclusion in the cost of production of the business as a whole, which is used in the calculation of a CP/CE ratio, the effect of this is to give the contractor a higher CP/CE ratio, and hence a lower profit rate on cost, than would be the case if inadmissible items were excluded. It has been suggested by one trade association that this is inequitable and that the same concept of admissibility of costs should be applied to both attributable costs and the cost of production of the business as a whole.

46. The Government representatives have told us that should it be thought that there are compelling reasons for bringing the two bases of calculating costs into line with each other, the effect on individual contractors' CP/CE ratios would in general be very small.

47. It is not within the scope of the Interim Review for us to comment on the use of a CP/CE ratio for a business as a whole to determine the capital employed attributable to an individual Government contract and hence the profit rate to be applied to that contract. The suggestion recorded in paragraph 45 raises a number of complicated issues which are related to the basic structure of the Formula and we do not propose to deal with this matter in the Interim Review.

SECTION IV—THE GOVERNMENT ACCOUNTING CONVENTIONS : INVESTMENT GRANTS AND OTHER SELECTIVE INCENTIVES

Investment Grants

48. The present practice is to include in attributable costs the amortisation of the net cost of fixed assets, as reduced by investment grants ; investment grants are similarly deducted from asset values in assessing capital employed. The Government submission of 6th January, 1970 pointed out that this is in accordance with the treatment of investment grants for tax purposes and with the recommendations of The Institute of Chartered Accountants in England and Wales on the treatment of investment grants in company accounts. A subsequent submission claimed, furthermore, that there are no grounds for shareholders to expect a return on capital which they have received free of charge.

49. Contractors have claimed that this treatment is wrong because it removes the incentive to invest which was the original intention of the grants and because it is a less favourable treatment than that formerly adopted by Departments in relation to investment allowances.

50. In our view, the arguments put forward to justify the present practice are not as strong as the contrary arguments. First, the accountancy profession has not given solid support for the "net" treatment of investment grants. Secondly, the principle that the Government should not provide a return on capital that the contractor has received free of charge is not consistently applied. Thirdly, we have not seen any indication that the introduction of investment grants was intended to cause companies to reduce prices in the short term, but rather to encourage investment ; the change from investment allowances to investment grants should not therefore operate to reduce contract prices.

51. The strongest argument, however, for a change in the present Convention is that the agreed 14 per cent target rate of return is based on the average return on capital earned by companies in the seven years from 1960 to 1966—a period almost entirely prior to the introduction of investment grants. The 14 per cent rate is therefore based on depreciation charges and asset values calculated without deducting investment grants ; the deduction of investment grants gives contractors a significantly lower rate of profit than that earned in the basis period.

52. We consider, therefore, that investment grants should not be deducted from fixed assets for the purposes of calculating depreciation charges and capital employed.

Building and other Capital Grants

53. Building grants in development and intermediate areas and capital grants in Northern Ireland are treated in the same way as investment grants and only the net cost admitted. It has been argued to us by one trade association that these grants should not be deducted in calculating depreciation and capital employed.

54. This item is similar to, although of less significance than, investment grants and we consider that it is logical to treat it in the same way as investment

grants. Accordingly, building and other capital grants should not be deducted from fixed assets for the purposes of calculating depreciation charges and capital employed.

The Regional Employment Premium (R.E.P.)

55. The present practice is to deduct the R.E.P. from a contractor's overhead costs. The Government submission of 6th January, 1970 stated that this is consistent with the purpose of the R.E.P. which was to make firms in development areas more competitive by reducing their costs. Some contractors have said to us that the intention of the R.E.P. was to provide an incentive by increasing companies' profits, or to finance special expenditure, and have drawn our attention to passages in the White Paper and the Board of Trade publication which appear to support their view.

56. We accept that the R.E.P. was intended primarily to reduce the costs of production in development areas; moreover, it seems to us that the agreed 14 per cent target rate of return on capital employed is all-embracing and the contractor should not receive an additional profit out of Government revenue grants. Accordingly, we have decided that the present treatment of the R.E.P. should not be changed.

Other Selective Incentives

57. The selective employment tax premium, which has now been withdrawn, should be treated as a reduction of overheads for the period when it was in operation. We consider that other selective incentives of a "revenue" nature, such as removal grants and operational grants should also be deducted from overhead costs.

58. One trade association has drawn our attention to the deduction of Shipbuilders' Relief in pricing Government contracts. It says that the Shipbuilders' Relief is a parallel form of assistance to the export rebate scheme which was intended to make exporting more attractive by making the rewards of exporting greater; for this reason, the association contends, Shipbuilders' Relief should not be deducted. We consider that similar considerations apply to Shipbuilders' Relief as to the R.E.P. and that it should, therefore, continue to be deducted.

SECTION V—THE GOVERNMENT ACCOUNTING CONVENTIONS : CAPITAL EMPLOYED

59. We have had fewer representations from contractors about the capital employed Conventions than about the attributable cost Conventions. Those that we have had have been concerned with the subjects of goodwill, preliminary expenses, and assets not in use, which are discussed in paragraphs 61 to 68. The capital employed Conventions have, however, been brought to our attention by the Government representatives in connection with the question of adjustment to the figure of 14 per cent in the Profit Formula, which is discussed in paragraphs 85 to 87. The basis of their argument on this subject has been that, for some contractors with whom a very considerable volume of non-competitive contracts is placed, capital employed calculated according to the current Conventions is greater than the capital employed appearing in their accounts and that a reduction in the figure of 14 per cent is required to compensate for this.

60. We have reviewed the present Conventions in the context of the basic issue which we have to determine in the Interim Review, which is whether the Profit Formula is a fair interpretation of the agreed 14 per cent target rate of return on capital employed. We have had details of the method of calculation of the 14 per cent target rate which was based on an analysis of the published accounts of about 1,500 companies between 1960 and 1966. We reviewed carefully the reasons for any differences between the Government Accounting Conventions and the accounting conventions used by industry, and the changes which we propose are all aimed at reducing the difference between the two bases of calculating capital employed. In general, we consider that the items included in capital employed for Government contract purposes should be identifiable from the contractor's Balance Sheet. We appreciate, however, that with capital employed as with attributable costs it is not possible to lay down rigid conventions applicable in all circumstances, and that in some cases it may be necessary to depart from Balance Sheet figures.

Goodwill and the Revaluation of Assets

61. Under the present Convention goodwill is excluded from assets on the grounds that it is an investment in aid of future profits. The J.R.B.A.C. have contended that goodwill should be treated as capital employed in so far as it has been paid for in cash or other assets or by the issue of shares at a fair valuation, and that these assets are just as much capital employed in the business as are other assets. They have said that goodwill often represents the cost of acquiring the fixed assets at current values rather than at unrealistic book values appearing in the books of the vendor and it also embraces payments for "know-how" and the potential for cost saving through rationalisation; as such it is inequitable that goodwill should be excluded from capital employed in entirety.

62. This subject is related to that of the revaluation of fixed assets; the present Convention is that purchasing Departments exclude any additions to Balance Sheet values of assets arising from revaluation. This Convention has provoked several submissions from contractors who have revalued their assets and feel that the resulting figures should be accepted for the purposes of both depreciation and capital employed.

63. In considering both these issues, we have referred to the basis of calculation of the agreed 14 per cent target rate. We have ascertained that the capital employed used in this calculation excluded any goodwill in companies' Balance Sheets and that the figures were adjusted to eliminate the effect of asset revaluations. If these two items had been included in capital employed, the average rate of return would have been significantly different. We feel, therefore, that in the Interim Review there should be no change in the Conventions in relation to goodwill or revaluations of assets. As these issues have a major effect on the return on capital employed earned by companies they will be relevant to the General Review.

Costs of Raising Capital and Preliminary Expenses

64. The costs of raising capital and preliminary expenses are normally excluded both from attributable costs and from capital employed. Several contractors have contended that these expenses are normal and recurring expenses in running a business and that they should be included either in capital employed or in attributable costs.

65. Companies generally write off these expenses against share premium accounts or other reserves with the result that they are neither included in capital employed nor shown as costs. We therefore consider that the present Convention should not be changed.

Assets not in Use

66. Under the present Convention, land and buildings not in occupation and plant and machinery demonstrably not in use, and also a proportion of such assets as are demonstrably underemployed, are normally excluded from capital employed. Any related expenditure may be excluded from attributable costs. The Government representatives explained to us that this Convention is rarely used to reduce a contractor's capital employed but that it is necessary to retain the Convention to deal with exceptional cases.

67. The J.R.B.A.C. have submitted that it is wrong in principle to omit these items from capital employed because it is normal in any industrial concern to have at any one time capital assets in the course of construction and a certain amount of spare capacity to meet fluctuations in demand or plant break-downs. It has further been contended by one trade association that these items should only be excluded from capital employed where the assets have become permanently surplus to requirements and serious steps are not being taken with a view to early realisation.

68. Assets not in use were not excluded from capital employed in the calculation of the agreed 14 per cent target rate, and we consider that as a general rule such assets should not be excluded for Government contract purposes. We recognise, however, that there may be exceptional circumstances in which it would be justifiable to exclude these items, for instance where assets are held for speculative purposes or for long term expansion not yet planned; there might also be cases where there has been an unreasonable delay in disposal of surplus assets which might justify exclusion from capital employed. The related expenditure on maintenance, insurance, etc. should follow the treatment of the assets.

Development Expenditure

69. Under the present Convention, development expenditure—mainly on private venture projects—may be included in capital employed even though

it may have been written off by the contractor in his accounts. We understand that relatively few companies, almost all in the aerospace industry, have had development expenditure added to their capital employed as a result of this Convention, but that the sums involved have been substantial in relation to the capital of these companies. This item has been a major factor underlying the Government's contention that adjustment is required to the figure of 14 per cent in the Profit Formula. Development expenditure in companies' Balance Sheets was excluded from capital employed in the calculation of the agreed 14 per cent target rate. However, if it had been included, it would not have had a significant effect on the rate of return.

70. We appreciate that it is extremely difficult in the early years of a development project to calculate the chances of recovery of development expenditure and that this difficulty, coupled with a sense of financial prudence, has led many contractors to write off this expenditure when it was incurred although this practice if carried too far may distort the trend of profits. We have come to the conclusion that there is no justification for including this development expenditure in the contractor's capital employed for Government contract purposes if the contractor does not show it in his own accounts. We see no reason why a contractor should make a different judgment of the value of the development work for the purpose of calculation of capital employed on Government contracts from that which he makes for the purpose of the report to his shareholders. We consider therefore that development expenditure should only be included in capital employed up to the value at which it is shown in the contractor's Balance Sheet, net of any provisions.

71. Where the contractor does carry development expenditure forward in his accounts it should still be necessary for the Government purchasing Departments to be satisfied that the amount is calculated in accordance with sound accounting principles and that the expenditure is likely to be recoverable. The Institute of Chartered Accountants in England and Wales has indicated its intention of laying down standards for the treatment of this item within about the next two years. These standards should therefore be available before the completion of the General Review and in the meantime, we consider that the present standard used by Departments should continue to apply, that is, that orders must have been received or must be likely to be received for the product under development and there must be a reasonable prospect of recovery of the expenditure in the prices of those orders. In addition, we consider that the admission of development expenditure should be limited to expenditure on projects where the development costs are only likely to be recovered over several years.

72. We think it appropriate that those contractors whose current profit rates are based on CP/CE ratios in which the figure for capital employed has included development expenditure not shown in their Balance Sheets should be given time to consider the treatment of this item in their accounts. Such contractors should therefore have the option of maintaining, until the date of publication of their next financial accounts, the old Convention relating to the admission of development expenditure in capital employed, in which case the existing Profit Formula based on a rate of return of 13½ per cent should continue to apply for the period concerned but the new Conventions relating to all other matters should apply from 1st August, 1970. The option should expire on 1st October, 1970 unless the intention to exercise it has been notified in writing to the Ministry of Technology by that date and any notification of the intention to exercise the option should be irrevocable.

Work in Progress

73. Under the present Convention, the book value of work in progress in the contractor's accounts may be adjusted to add back the amount of general provisions deducted therefrom or to include what purchasing Departments judge to be a realistic figure for overhead expenses. These adjustments have been mentioned by the Government as examples of the way in which the application of their Conventions produces a higher figure for capital employed and hence a higher profit figure than would be the case if industry's accounting conventions were employed.

74. We have mentioned above our view that there should be as few differences as possible between a contractor's capital employed as shown by his accounts and the capital employed for Government contract purposes. We see no reason for Departments to adjust the value which the contractor puts upon his work in progress, which is approved by his auditors and submitted to his shareholders. In our view, therefore, the net Balance Sheet figures for work in progress should be used for computing capital employed for Government contract purposes.

Trade Debtors

75. Under the present Convention, Departments also add back any general provisions deducted from debtors. As in the case of work in progress, we consider that the contractor's view, as expressed in his accounts, of the value of trade debtors should determine the figure which is included in capital employed for Government contract purposes; accordingly, no adjustment should be made to the net book figure to add back general provisions. Departments may also increase the figure for debtors to take account of increases becoming known after the Balance Sheet date due to settlement of prices previously included at provisional figures. This adjustment usually relates to specific Government contracts where the length and complexity of the contract may make it impossible to take account of firm prices in the Balance Sheet; it is different in character from the adjustment of general provisions deducted from debtors and we consider that this Convention should remain unchanged.

Taxation Provisions

76. In computing capital employed under the current Conventions, Departments treat taxation as a liability only to the extent of the amount due and payable at the beginning of the year under review. This Convention is favourable to contractors since it usually results in the deduction from assets of a lower figure than the contractor includes in his Balance Sheet as a current liability.

77. Under the present system of taxation, which differs from that in force for most of the basis period, companies normally do not treat as a current liability the Corporation Tax chargeable on the profits of the year ended on the Balance Sheet date, payable on average about a year later. We consider that the provision for this Corporation Tax, as well as any taxation equalisation account including that set up in respect of development expenditure, should be treated as capital employed for Government contract purposes. All other taxation provisions should be treated as liabilities and deducted from capital employed. This is reasonably in line with the way in which taxation provisions were treated in company accounts under the old system of taxation.

SECTION VI—THE PROFIT FORMULA

78. The New Profit Formula, which was introduced on 26th February, 1968, is described in a paper prepared jointly by the Treasury and the C.B.I. which is set out in Appendix B. Our review of this Profit Formula has been confined to those elements of the Formula mentioned in our terms of reference. Thus we have considered whether a change is needed in the average CP/CE ratio of 1½ to 1 which was used as the basis for calculating the new Profit Formula and also whether the remaining differences between the Government Accounting Conventions, after taking our changes into account, and those used by industry require the profit rates in the Formula to be based on a figure other than 14 per cent in order to achieve the agreed target. We have also considered whether an adjustment is required in the profit rates to be applied from the implementation of our decisions on 1st August, 1970 until the General Review, to compensate for any failure of the Formula, in conjunction with the Conventions, to meet the agreed target rate over the period from the introduction of the new Profit Formula to 31st July, 1970. In accordance with our terms of reference we have not concerned ourselves with the basic structure or level of the agreed target or with the aggregation of risk and non-risk work.

The Average CP/CE Ratio

79. The average CP/CE ratio is used to convert part of the return on capital employed in the Profit Formula into a return on cost of production. The ratio of 1½ to 1 used in the Profit Formula effective since 26th February, 1968, was based on a summary by the Ministry of Technology of the accounts of 81 contractors for their financial years ending during 1966. The Ministry have subsequently extended this calculation to cover the years 1967 and 1968 (the most recent year for which figures are available) and to include a number of contractors who deal with the Ministry of Defence. (The average figure for the three years 1966, 1967 and 1968 is 1·29 to 1.

80. The Ministry of Technology have given us the names of the contractors included in this summary for each of the three years. The 1966 list comprises all those contractors for whom financial statements were prepared by the Ministry's Directorate of Accountancy Services ; this appears to us to include all the major Government contractors and to represent a satisfactory sample. For 1967 and 1968 some major contractors have been omitted because agreed figures are not available but we have been assured by the Ministry that the omissions have not had a significant effect on the overall average.

81. In summarising figures to calculate the overall average, the Ministry of Technology have applied a weighting factor to each contractor's capital employed and cost of production equal to the estimated proportion of the contractor's total turnover which is represented by Government work. The weighting does not affect the CP/CE ratio of the individual contractor but it means that a contractor with a high proportion of Government work will have a greater effect on the overall average than another contractor of the same size with a low proportion of Government work. The weighting of the figures in fact has very little effect on the overall average.

82. In view of the purpose for which the average CP/CE ratio is to be used, we think it appropriate that the calculation should be based on a sample of Government contractors rather than on the figures for British industry in general, and also that the figures should be weighted to take account of the proportion of Government business, as has been done by the Ministry of Technology.

83. The Ministry of Technology have told us that the figures for cost of production and capital employed for each company have been calculated in accordance with the Conventions. We have obtained from the Ministry the individual figures relating to 15 contractors in each of the years 1966, 1967 and 1968. With the permission of the Ministry we have made the figures of six of the largest contractors available to the companies concerned, and asked whether they were agreed by the companies. This revealed certain differences and we have made appropriate adjustments which have had the effect of reducing the average CP/CE ratio from 1.29 to 1 to 1.25 to 1. We have accepted the figure of 1.25 to 1, based on the three years 1966, 1967 and 1968, as the average CP/CE ratio of Government contractors, based on the old Conventions.

84. In order to obtain an average CP/PE ratio to be used during the remainder of the period up to the General Review, we have estimated the effect on the average of 1.25 to 1 of our changes in the Conventions. We have obtained information from the Ministry of Technology to show what the average over the three years 1966, 1967 and 1968 would have been if the changes which we have made in this Report had been in force during the period. The changes in the Conventions relating to the treatment in capital employed of development expenditure, work in progress, trade debtors and taxation provisions reduce the capital employed and therefore increase the ratio ; this is to some extent offset by the change in the treatment of investment grants which increases both capital employed and cost of production but on balance reduces the ratio. After examining the figures provided by the Ministry of Technology we have concluded that the combined effect of these changes is to increase the average ratio of 1.25 to 1 based on the old Conventions to 1.36 to 1. We have accordingly used this ratio in calculating the profit rates in the Formula for the remaining period up to the General Review.

Adjustments due to Differences in Accounting Conventions

85. We have also been asked to report whether the remaining differences between the Government Accounting Conventions and those used by industry require the profit rates in the Formula to be based on a figure other than 14 per cent in order to achieve the agreed 14 per cent target. The Government's view at the time of negotiating the Profit Formula in 1968 was that the Conventions then in force had the effect of giving contractors a higher return than would be the case if the accounting conventions employed by industry were adopted ; the Government therefore wished to adopt a lower figure than the agreed 14 per cent target rate when computing the return on capital based on the Government Accounting Conventions. This view was not accepted by industry but it was agreed that, as a compromise pending our decision, a return on capital of 13½ per cent should be used provisionally in applying the new Profit Formula.

86. In support of their view the Government representatives have given us evidence of the effect of applying their Conventions to the accounts of a sample of large Government contractors in the years 1963, 1965, 1966 and

1967. These figures show that capital employed on the basis of the Conventions was on average, considerably higher than the book figures and therefore that a given profit rate would be likely to produce a higher profit figure on the basis of the Conventions than on the basis of the book figures. The difference was due to the inclusion in capital employed under the Conventions of large amounts of development expenditure which had been written off by the contractors and also to the treatment of work in progress, trade debtors and taxation provisions. The Government representatives have also told us that if their case for rates in the Formula based on a figure lower than 14 per cent were not accepted, they would contend that the Conventions should be changed so as to eliminate the differences between the Government's figures and the book figures.

87. We have not been able to accept the case for the adoption of a lower figure than 14 per cent for the basis of the Formula, which is applicable to all contractors, on account of differences in accounting conventions which affect relatively few contractors. We have, however, decided that changes to the Conventions relating to development expenditure, work in progress, trade debtors and taxation provisions should be made which should eliminate most of the differences from book figures. The few remaining differences between the method by which capital employed was defined in the calculation of the agreed 14 per cent target rate and the method used for Government contract purposes are not sufficient to justify any significant alteration to the figure of 14 per cent as the basis of the Profit Formula.

Adjustments to Compensate for the effect of the Profit Formula and the Conventions in use since 26th February, 1968.

88. The terms of reference for the Interim Review in the Annex to the Memorandum of Agreement provide that there should be no retrospective adjustment to the Profit Formula, but that the purpose of any adjustment should be to get as near as possible to meeting the agreed 14 per cent target over the full three years up to the General Review. This means that we must take into account, in determining the profit rates to be applied for the remainder of the period, the rates which have applied to date since 26th February, 1968 and the effect of the Conventions in use during this period.

89. The definition of the period over which the agreed 14 per cent target rate should, so far as possible, be met is one of difficulty. Our terms of reference refer to "the full three years up to the General Review", but because of the need to await agreed figures, the General Review is not likely to be completed until near the end of 1973. We have consulted the Government and the C.B.I. and they have agreed that the appropriate period to be taken should be the whole period from the introduction of the new Profit Formula up to the completion of the General Review, since it was the intention of the two parties to the Agreement that the Profit Formula, revised if necessary in the Interim Review, should give the agreed 14 per cent target rate of return until such time as information was available from the General Review to determine a new target rate. On this basis, 29 months have elapsed between the introduction of the new Profit Formula (26th February, 1968) and the date of this Report (31st July, 1970). The whole period between the introduction of the new Profit Formula and the completion of the General Review (say 31st December, 1973) will be 70 months; approximately two-fifths of the whole period has therefore now elapsed.

90. The Profit Formula hitherto applicable has been based on a return on capital of $13\frac{1}{2}$ per cent, $\frac{1}{2}$ per cent below the agreed 14 per cent target rate.

Furthermore, the profit rates have been based on a CP/CE ratio of 1·33 to 1 whereas we consider that the average CP/CE ratio on the basis of the old Conventions was 1·25 to 1. In addition, the old Convention relating to investment grants has had the effect of further reducing profits. On the other hand, the old Convention relating to development expenditure in capital employed has probably resulted in the inclusion of larger sums in capital employed than would have been the case had the new Conventions been in force, and the Conventions relating to work in progress, trade debtors and taxation provisions have also had the effect of increasing capital employed.

91. From the material available to us and having exercised our judgment on matters which cannot be precisely determined, we have concluded that the effect of the use of the old Conventions and the Profit Formula based upon a return on capital employed of 13½ per cent has been to give an average rate of return of about 13½ per cent computed on the basis of the new Conventions. We consider that the result of the Profit Formula hitherto applied was significantly out of line with the agreed target and that, therefore, an upward adjustment of the profit rates should be made to meet as near as possible the agreed 14 per cent target rate over the whole period up to the completion of the General Review. As our adjustment will not be retrospective, the average return on capital employed to be applied from 1st August, 1970 should be about 14½ per cent which will achieve a fair interpretation of the agreed 14 per cent target over the whole period.

The Profit Rates

92. The profit rates to be used in the Profit Formula over the remainder of the period up to the completion of the General Review should be as follows:—

Risk work:

12 per cent on capital employed plus 3 per cent on cost providing (on the basis of the CP/CE ratio of 1·36 to 1) an average return on capital employed of 16·1 per cent.

Non-risk work:

8 per cent on capital employed plus up to 4 per cent on cost for efficiency, 2 per cent being the intended average addition, providing (on the basis of the CP/CE ratio of 1·36 to 1) an average return of 10·7 per cent on capital employed.

93. The weighted average of the return of 16·1 per cent on risk work and 10·7 per cent on non-risk work, on the basis of the proportion of risk to non-risk work of 2 to 1, is 14·3 per cent. We consider that the use of these profit rates in the Profit Formula for the remainder of the period up to the completion of the General Review will achieve a fair interpretation of the agreed 14 per cent target over the whole period.

SECTION VII—SUMMARY OF OUR CONCLUSIONS REGARDING CHANGES IN THE GOVERNMENT ACCOUNTING CONVENTIONS AND THE PROFIT FORMULA

The Government Accounting Conventions

94. We have decided that the Government Accounting Conventions should be amended as follows:—

- (a) The contractor's own depreciation rates should be accepted for the purpose of attributable costs provided that they are consistent and reasonable; the depreciation charge included should not be affected by the treatment of investment grants in the contractor's accounts (paragraph 15).

The difference between the total written down value for Government contract pricing purposes and the net book value of existing assets should be eliminated by an adjustment to the company's depreciation charge over a future period in accordance with a plan agreed between the contractor and the Department (paragraph 16).

- (b) Salesmen's commissions should generally be treated as part of their salaries (paragraph 23).
- (c) Payments under employees' profit-sharing schemes should be included in attributable costs where they are accepted by the Inland Revenue as charges against the company's profits for tax purposes (paragraph 32).
- (d) General stock losses and obsolescence, including provisions, which cannot be charged directly either to Government or civil work should be included in attributable overhead costs (paragraph 35).
- (e) Reasonable redundancy payments in excess of the rates laid down by Statute, made under the terms of a bona fide scheme, should be included in attributable costs (paragraph 39).
- (f) Subscriptions and donations should be included in attributable costs if they are accepted by the Inland Revenue as charges against the company's profits for tax purposes (paragraph 41).
- (g) If any expenditure is excluded on the grounds that it is unnecessary, extravagant or wasteful, the contractor is entitled to a full explanation. In cases where only a small proportion of a contractor's turnover is made up of non-competitive Government contracts, there should be a presumption that all expenses were reasonably incurred (paragraph 44).
- (h) Investment grants should not be deducted from fixed assets for the purposes of calculating depreciation charges and capital employed (paragraph 52).
- (i) Building grants and other capital grants should not be deducted from fixed assets for the purposes of calculating depreciation charges and capital employed (paragraph 54).
- (j) Land and buildings not in occupation and plant and machinery not in use should not be excluded from capital employed unless they are held for speculative purposes or for long term expansion not

yet planned, or where there has been unreasonable delay in disposal of surplus assets. Related expenditure on maintenance, insurance, etc., should follow the treatment of the assets (paragraph 68).

- (k) Development expenditure should only be included in capital employed up to the value at which it is shown in the contractor's Balance Sheet, net of any provisions (paragraph 70), subject to a transitional arrangement (paragraph 72, and see paragraph 100).

Development expenditure should be included only if it is likely to be recovered over several years and if orders have been received or are likely to be received for the product under development and there is a reasonable prospect of recovery of the expenditure in the prices of those orders (paragraph 71).

- (l) The net Balance Sheet figures for work in progress should be used for computing capital employed (paragraph 74).

- (m) The net Balance Sheet figures for debtors should be used for computing capital employed (paragraph 75).

This should not preclude raising the Balance Sheet figures to take account of increases becoming known after the Balance Sheet date due to settlement of prices previously included at provisional figures.

- (n) The provision for Corporation Tax on profits of the year ended on the Balance Sheet date and the taxation equalisation account including that set up in respect of development expenditure should be treated as capital employed; all other taxation provisions should be treated as liabilities (paragraph 77).

95. All the Government Accounting Conventions which we have not mentioned in paragraph 94 should at this stage remain unchanged.

96. It has been agreed by the Government and the C.B.I. that we should undertake a further study of the subject of marketing and selling expenses to endeavour, in consultation with both sides, to find a more satisfactory way of attributing these costs to Government contracts (paragraph 25). We will also hold ourselves available to give a decision on any point which may be referred to us from the discussions which are shortly to take place on the treatment of research and development expenditure (paragraph 30). We hope that Government Departments and contractors, acting together, can take further steps to elaborate and clarify other Conventions and to bring about greater uniformity in the definition and classification of costs (paragraph 12).

The Profit Formula

97. The average CP/CE ratio should be taken to be 1·36 to 1 (paragraph 84).

98. The profit rates to be used in the Profit Formula for the remainder of the period up to the General Review should be as follows (paragraph 92):—

Risk work

12 per cent on capital employed plus 3 per cent on cost providing (on the basis of the CP/CE ratio of 1·36 to 1) an average return on capital employed of 16·1 per cent.

Non-risk work

8 per cent on capital employed plus up to 4 per cent on cost for efficiency, 2 per cent being the intended average addition, providing (on the basis of the CP/CE ratio of 1.36 to 1) an average return of 10.7 per cent on capital employed.

Date from which the Changes are to be Effective

99. Our changes in the Conventions and the Profit Formula should, subject to the exception given in the following paragraph, be effective from 1st August, 1970. This means that where a contractor does not exercise the option referred to in the following paragraph, risk contracts for which no price arrangement has been agreed by 1st August, 1970 and to which the Profit Formula introduced on 26th February, 1968 would have applied, and non-risk work carried out after 1st August, 1970 for which no arrangement for profit has been agreed by that date, will be priced using the revised Profit Formula and using overhead rates and a CP/CE ratio calculated on the basis of the revised Conventions.

100. Contractors whose current profit rates are based on CP/CE ratios in which the figure for capital employed has included development expenditure not shown in their Balance Sheets should have the option of maintaining, until the date of publication of their next financial accounts, the old Convention relating to the admission of development expenditure in capital employed. If they exercise this option the existing Profit Formula based on a rate of return of 13½ per cent should continue to apply for the period concerned but the new Conventions relating to all other matters should apply from 1st August, 1970 in the way set out in the previous paragraph. The option should expire on 1st October, 1970 unless the intention to exercise it has been notified in writing to the Ministry of Technology by that date and any notification of the intention to exercise the option should be irrevocable.

101. We wish to record our appreciation of the help given to us in our review by representatives of Government Departments and of industry, and also of the invaluable assistance which we have received from Mr. James Scott, a partner in Messrs. Binder, Hamlyn & Co. the Secretaries of the Board.

W. H. LAWSON
R. A. BARR
CALDECOTE
ST. JOHN ELSTUB
ROBERTHALL

31st July, 1970.

APPENDIX A

REVIEW BOARD FOR GOVERNMENT CONTRACTS

Memorandum of Agreement between Her Majesty's Government and the Confederation of British Industry covering the establishment of the Review Board for Government Contracts, its functions, and related matters.

The Background

1. On 26th February, 1968, the Chief Secretary, H.M. Treasury, announced to Parliament that the Government had reached agreement with industry on new arrangements for placing and pricing the non-competitive Government contracts covered by the existing profit formula. He stated :—

"The Government and industry have agreed that the aim of the formula should be to give contractors a fair return on capital employed ; that is to say equal on average to the overall return earned by British industry in recent years. The yardstick will be the average of industry's earnings over the last seven years for which figures are available—1960 to 1966. This gives a figure of 14 per cent on capital employed. . . .

"The Government recognise the importance of fair profits for their contractors . . . and accept the view that fixed prices freely negotiated should in general not be retrospectively modified. . . . Nevertheless, arrangements must be made to deal with excessive profits, given that there is no competitive check on the agreed prices. . . .

"Agreement has been reached on a proposal to set up an impartial Review Board, and to secure acceptance of its rulings by a new contract condition. Both sides could refer contracts where profits of 27½ per cent or more on capital employed and losses of 15 per cent or more had been made, to establish whether any reimbursement or compensation was justified. In exceptional cases, the Board might review contracts referred to it by either side within these percentages, where there was evidence that prices had not been fair and reasonable.

"In addition to reviewing individual contracts and giving rulings which both sides would agree in advance to accept, the Review Board would also be given the task of collating the evidence for a review of average earnings on contracts. For this purpose, the Review Board would act in an advisory capacity. A review after three years, which could relate actual earnings on this work to the latest trends in overall average earnings of British industry, would be in the interests of both sides."

2. It was subsequently agreed between the Government and the Confederation of British Industry (from now on in this paper called the C.B.I.) that the Review Board should also carry out an Interim Review on certain topics. The Annex to this paper deals with this Review.

3. This paper sets out the terms of agreement reached between the Government and the C.B.I. covering the establishment of the Review Board, its functions, and related matters.

Establishment and Administrative Arrangements

4. The Board shall be known as "The Review Board for Government Contracts"—from now on in this paper called the Review Board. It shall be independent of both the Government and industry.

5. (a) The Review Board shall consist of a Chairman and four other Members.
 - (b) The Treasury and the C.B.I. shall each nominate two independent candidates for appointment as Members, and shall consult each other to ensure that both these nominations and also the nomination for the Chairmanship are acceptable to both parties.
 - (c) The Treasury shall appoint the Chairman and other Members. Subject to (d) and (e) below these appointments shall be for a period of not less than three and not more than five years. These appointments may be renewed.

- (d) Appointments may be terminated by the Treasury after consultation with the C.B.I.
- (e) Members may resign at any time by giving notice in writing to the Treasury.
- (f) Casual vacancies, caused for example by resignation, shall be filled after consultation between the two parties as provided in (b) above.
6. The Secretariat necessary to service the Review Board shall, unless and until the Review Board shall recommend otherwise, be provided by the engagement of a firm of professional accountants, whose terms of appointment and terms of reference shall be determined by agreement between the Review Board, the Government and the C.B.I. If the Review Board recommends that it should employ other professional advice or staff of its own, the number, pay and conditions of these staff shall also be determined by agreement between the said three parties.
7. The arrangements for accommodating the Review Board and supporting staff shall be agreed between the Review Board, the Government and the C.B.I.
8. The Government shall determine, after consultation with the C.B.I., the remuneration of the Chairman and other Members of the Review Board.

Costs

9. The arrangements for meeting the running costs of the Review Board will be determined by agreement between the Treasury and the C.B.I. in consultation when appropriate with the Review Board.
10. Costs incurred by Government departments, by contractors or by sub-contractors arising from reference of individual contracts or sub-contracts to the Review Board shall lie where they fall and those incurred by contractors or sub-contractors will be regarded as allowable costs in arriving at overhead rates.

Procedure

11. Subject to the arrangements set out below and agreed between the Treasury and the C.B.I. as necessary for the review of individual contracts and sub-contracts and for the general review, the Review Board shall determine its own procedures and all other matters not otherwise provided for in this paper.

Government Accounting Conventions

12. The evidence to be submitted by Departments, contractors and sub-contractors for the review of individual contracts or sub-contracts and by the Government and industry for the general review shall be computed in accordance with the Government's accounting conventions. For individual contracts and sub-contracts the relevant conventions shall be those used in the pricing. If, as a result of the Interim Review by the Review Board, or discussions between the Government and the C.B.I. adjustments are made to the conventions, such adjustments will be reflected in the annual returns as from a date agreed by the Government and the C.B.I.

Functions—Review of Individual Contracts and Sub-Contracts

13. In fulfilling its function of reviewing and giving rulings on individual contracts and sub-contracts, the Review Board will consider only Government profit formula risk contracts or sub-contracts, and further will consider only such contracts or sub-contracts as may be referred to it in accordance with the provisions of paragraphs 15, 16 and 17 of this paper. When a reference is made to it, the Review Board shall assess whether the price negotiated was fair and reasonable, and in the light of this assessment determine whether any payment should be made by one of the two parties to the reference to the other and, if so, how much.

14. For the purpose of interpreting the general direction given in paragraph 13 above and subject to the provisions of paragraphs 15, 16 and 17 below:—

- (a) Government profit formula risk contracts comprise those contracts placed with contractors by Government departments which—
- (i) incorporate a condition (normally Standard Condition 48 in Form CCC/Stores/1) covering availability of information and requiring the contractor to provide information to the department on request in connection with post-costing investigation of the contract; and
 - (ii) include in the price an allowance for profit calculated at the rate applicable to risk work as agreed between the Government and the C.B.I. in October, 1968 and set out in paragraph 4 of the Treasury's paper entitled "Profit Formula Review"—Arrangements agreed with industry to be applied from 26th February, 1968".
- (b) Government profit formula risk sub-contracts comprise sub-contracts placed by contractors for the purpose of and in connection with their own fulfilment of Government profit formula risk contracts, and such other sub-contracts as may be specified by the department under the terms of any contract. Sub-contracts placed by acceptance of the lowest competitive tender, or to which the non-risk rate of profit applies under sub-paragraph 13(c) of the Treasury's paper referred to in sub-paragraph (a)(ii) above, are not Government profit formula risk sub-contracts.

15. Government profit formula risk contracts will incorporate a condition (normally Standard Condition 50 in Form CCC/Stores/1) covering reference of the contract to the Review Board in certain specified circumstances: such a reference may be made either by the Government department or by the contractor or jointly by both these parties to the contract. Government profit formula risk sub-contracts of a value exceeding £100,000 (or on occasion of a lower value) may incorporate a similar condition: if so, the sub-contract may be referred to the Review Board either by the Government department concerned in the related main contract or by the sub-contractor or jointly by both.

16. A contract or sub-contract incorporating a condition such as is mentioned in paragraph 15 above may be referred to the Review Board by any party entitled to make such a reference if it appears from post-costing that a profit of or exceeding 27½ per cent on capital employed or a loss of or exceeding 15 per cent on capital employed has been made on the contract or sub-contract in question. These figures do not of themselves involve any presumption of whether any payment should be made by one of the two parties to the reference to the other; it is not practicable to define a level at which profit automatically becomes excessive or loss unconscionable.

17. In exceptional cases, although the profit or loss made by the contractor or sub-contractor was not such as to justify a reference under the terms of paragraph 16 above, any party entitled to make a reference may do so if it considers that the achievement of a fair and reasonable price was frustrated because the information on which it was based has proved to be materially inaccurate or incomplete.

18. For the purposes of paragraphs 13, 15, 16 and 17 above and for acting upon the provisions in the conditions in contracts and sub-contracts which relate to making references to the Review Board, notice of a reference to the Review Board shall have effect only on and from the date on which it is received by the Review Board's Secretariat and also only if:—

- (a) the notice is in writing, identifying the parties to the reference, the contract or sub-contract being referred, and the specific circumstances which have occasioned the reference; and
- (b) except when the reference is made jointly by both the Government department on the one hand and the contractor or sub-contractor as

the case may be on the other hand, the party making the reference has simultaneously sent a copy of the notice to the other party to the reference.

19. In considering any reference to it of an individual contract or sub-contract, the Review Board shall have especial regard to :—

- (a) the information available to the department, and to the contractor or the sub-contractor as the case may be, when the price was fixed ; and
- (b) the standard of efficiency with which the contract or sub-contract was performed.

20. Either party to a reference or both parties jointly may bring further considerations to the attention of the Review Board if these could in their view have a bearing on its deliberations. Relevant considerations might include for example :—

- (a) the degree of risk involved in performing the contract or sub-contract ;
- (b) the record of profits achieved or losses sustained by the contractor or sub-contractor on Government profit formula work over recent years ;
- (c) in references of sub-contracts by the department or the sub-contractor, respective responsibilities of the department, the contractor and the sub-contractor for the situation leading to the reference.

21. In connection with a reference to it of an individual contract or sub-contract, the Review Board may have occasion to consider a contingency provision which had turned out after post-costing to have been unnecessary in whole or in part. The Review Board shall examine such a provision only from the aspect of the situation at the time of price fixing and in so doing shall have especial regard to :—

- (a) whether the contingency provision was openly declared and agreed at price fixing and accepted then by reference either to the need for a similar provision in a comparable previous contract or to previous experience or the length or complexity of the contract or the degree of technical innovation involved in the performance of the contract ; and
- (b) whether the nature of the contingency and the amount of the provision were fair and reasonable in the light of the information available to the two sides at price fixing.

22. The Treasury and the C.B.I. have agreed the following framework, within which the Review Board would determine its own procedures, for the reference to the Review Board of individual contracts and sub-contracts :—

- (a) The two parties to a reference shall present their evidence in writing to the Review Board and make it available to the other party. The Review Board shall decide whether it wishes the two parties to present further evidence, whether written or oral, and whether it wishes to call for evidence from the main contractor on a sub-contract under reference, or from a sub-contractor when a main contract is under reference.
- (b) References of individual contracts or sub-contracts may be examined and determined by the Chairman and two other members only one being a Member nominated by the Treasury and the other a Member nominated by the C.B.I.
- (c) The Review Board shall give its decision on a reference in a written report signed by the Chairman to the parties to the reference. A copy shall be made available to the Treasury. In the event of disagreement between the other Members as to the quantum of an award, the Chairman's decision shall prevail. If any decision is not unanimous this shall not be revealed.
- (d) The Review Board shall publish an annual report on its work. Decisions on all individual cases referred to it shall be included, with an assessment of the general considerations (in particular those listed in paragraph 19

above) which led to these decisions. The Review Board will not be obliged to publish the names of the contractors or sub-contractors concerned in these decisions. If the Review Board decides in any particular case to identify the parties to the reference, it shall inform them of this decision in advance of publication of the annual report.

23. It will at all times remain open to Government departments and contractors/sub-contractors to agree to settle between them in any way any matter arising out of a contract/sub-contract which could be or has been referred as provided above to the Review Board. Whenever such a settlement is agreed upon, whether or not a reference has already been made to the Review Board and whether or not the terms of the settlement involve payment, any party to the settlement may report its terms to the Review Board for information. Any such report will, unless the parties to the settlement agree otherwise, be confined to statements of fact and will whenever possible be in a form agreed between the parties as part of the terms of the settlement.

Functions—The General Review

24. The Government and the C.B.I. have agreed that the Review Board shall carry out a general review which shall cover:—

- (a) Industry's overall average earnings in the period 1st January, 1969 to 31st December, 1971 (based on contractors' annual accounts for the three financial years ending in that period), and at three-yearly intervals thereafter, on Government contracts to which the revised Profit Formula referred to in paragraph 1 above applies, taking risk contracts and non-risk contracts separately.
- (b) The revised Profit Formula referred to in paragraph 1 above (or the Profit Formula as further revised in the light of any subsequent modifications) in order to ascertain whether its use has achieved—
 - (i) the general intention of giving overall average earnings on Government profit formula work equivalent to the overall average earnings of manufacturing industry on its work, on the assumption that the necessary statistics on the latter can be made available to the Review Board to enable the appropriate comparison to be made;
 - (ii) the specific aim for the period under review which the profit formula rates in force at the time of the review are intended to achieve (for the period up to the first review the agreed yardstick is a figure of 14 per cent on capital employed).

This review—from now on in this paper called the general review—will result in a written report from the Review Board to the Treasury, containing its recommendations for future action. The report will be made simultaneously available to the C.B.I. for consideration by industry. The Government and the C.B.I. have agreed that the report will form the basis for discussion between them.

25. It is the intention of the Treasury and the C.B.I. that the following information, required to enable it to carry out the general review, should be made available to the Review Board:—

- (a) Annual returns from contractors selected by the Review Board accompanied by a copy of their audited financial accounts. (Departments will disclose the pattern of the contracts they place with the contractors engaged in profit formula work in the form and detail required by the Review Board to enable it to obtain adequate coverage of the field in determining those contractors from whom such reports will be required. The names of these contractors will then be passed to the C.B.I. which, in conjunction with the trade associations concerned, will use its best endeavours to ensure that each contractor provides the Review Board with an annual return to enable the general review to be carried out.)

(b) These annual returns, made out in the form required by the Review Board, shall be accompanied by a report from the contractor's auditors and shall comprise:—

(i) A statement analysing the financial accounts figures for sales, cost of sales and profit or loss (expressed as a percentage on cost of sales) under the following headings:—

A. Government profit formula work priced under the new arrangements, divided between work which incorporates:

- (1) the risk rates of profit ; and
- (2) the non-risk rates of profit.

B. Other work.

- (ii) If it is not apparent on the return, a reconciliation of the figures on the statement with the audited financial accounts.
- (iii) A statement showing the total of adjustments in respect of contracts invoiced in prior years.
- (iv) A statement on the adjustments made to the figures on the return in order to comply with Government accounting conventions.
- (v) A statement showing the overall average ratio of cost of production to capital employed (CP/CE ratio) in the year, as computed for purpose of Government contracts, confirming that they have been agreed with the Government departments concerned, or recording that the figures have not been agreed or that items are in dispute.
- (vi) A statement showing the basis on which apportionments have been made in the annual return as between Government profit formula risk contracts and non-risk contracts and other work.

(Notes for the guidance of contractors in completing their annual returns will, in due course, be agreed between the Review Board, the Government and the C.B.I.)

26. The Review Board will, on the basis of these annual returns, provide the Government with annual reports setting out the overall average percentage of profit related to average capital employed divided as between risk and non-risk contracts for the contractors furnishing returns ; no return so made by any individual contractor will be made available in any way to any Government department.

27. The Review Board shall, on the basis of these annual returns and its annual reports to the Treasury based on these returns, review the Government profit formula at three-yearly intervals. In conducting these general reviews the Review Board may take account not only of the submissions made to it by the Government and those organisations representing industry generally or any particular industry but also of any representations made to it by any person or body it wishes to consult. The Review Board, taking account of the effect of the Government's accounting conventions, shall then advise whether:—

- (a) the Profit Formula has achieved its agreed objective for the three years under review in the light of the evidence of actual earnings on Government profit formula work, both risk and non-risk ;
- (b) the agreed objective requires any modification ;
- (c) the Profit Formula rates for risk and non-risk work require modification for the next three years in the light of its advice on (a) and (b) above.

ANNEX TO APPENDIX A

(see paragraph 2)

INTERIM REVIEW

1. The Government and the C.B.I. have agreed that the Review Board shall be asked to report on the new Profit Formula which came into effect on 26th February, 1968 as soon as possible, and in any event within a year of being set up on 1st August, 1969. The basic issue to be determined in this report will be whether this formula is a fair interpretation of the agreed 14 per cent target on capital employed for the first three years. The Government and the C.B.I. have agreed that both sides would accept the decision of the Review Board on all the points covered in this appendix as final, and that—

- (a) no adjustment to the profit rates would be made unless the new Profit Formula appeared to the Review Board to be significantly out of line with the target ;
- (b) any adjustment upwards or downwards would be applied on a date to be determined by the Review Board to—
 - (i) risk contracts where no price arrangement has been agreed on the date the adjustment takes effect ;
 - (ii) non-risk work carried out after that date for which no arrangement for profit has been agreed by that date ;
- (c) while retrospective adjustment would be ruled out under (b) above the purpose of any adjustment would be to get as near as possible to meeting the agreed 14 per cent target over the full three years up to the general review, which will be concerned with the level of profits actually achieved under the new Profit Formula ;
- (d) the Interim Review would not be concerned with the basic structure of the agreed target and the aggregation of risk and non-risk work, which would not be altered in advance of the general review.

2. The Government and the C.B.I. have agreed that the Review Board should be asked to report on the following matters as part of the main Interim Review :—

- (a) whether a change is needed in the average ratio of cost of production to capital employed of 1½:1 which has been agreed as the basis for calculating the new Profit Formula ;
- (b) whether certain costs which are at present not accepted as charges to Government contracts should in future be so accepted, and whether the allowances for depreciation included in costs should be based on the charges made by contractors in their accounts instead of by reference to Inland Revenue rates ;
- (c) whether any, and if so what, change should be made in the treatment of (i) investment grants for the purposes of assessing the capital employed by Government contractors and (ii) investment grants and other selective incentives for the purposes of overheads ;
- (d) whether the remaining differences between the Government's accounting conventions and those used by industry require adjustments in the profit rates to achieve the agreed target.

If the Review Board should be able to make a report on (c) above in advance of its main Interim Review the Government and the C.B.I. have agreed that any change decided by the Review Board should be applied from a date to be determined by the Review Board, but that no retrospective adjustment should be made to points already settled in pricing negotiations between Government departments and contractors.

3. The Government and the C.B.I. have agreed that the written evidence made available by each side to the Review Board for the Interim Review shall be made available to the other.

APPENDIX B

PROFIT FORMULA REVIEW—ARRANGEMENTS AGREED WITH INDUSTRY TO BE APPLIED FROM 26th FEBRUARY, 1968

Aim of the formula

1. The Chief Secretary informed the House of Commons on 26th February, 1968 that the Government and industry had agreed that the aim of the formula to be applied to non-competitive Government contracts should be to give contractors a fair return on capital employed; that is to say, a return equal on average to the overall return earned by British industry. The yardstick which it has been agreed shall be used for the period up to the first general review (see paragraph 6) is the average of industry's earnings over the last seven years for which figures are available. These figures, which are derived from Board of Trade figures adjusted by the Monopolies Commission to the historic cost basis, are:—

	per cent				
1960	16·6
1961	14·0
1962	12·6
1963	13·5
1964	14·7
1965	13·9
1966	12·0

The unweighted average for the seven years 1960 to 1966 comes to 13·9 per cent. This gives the yardstick of 14 per cent on capital employed (that is, 13·9 per cent rounded) to which the Chief Secretary referred in his statement.

2. The Government has expressed the view that in non-competitive Government contracts, the accounting conventions which it adopts for the purpose of computing capital employed and for determining what expenditure can properly be included in costs have the effect of yielding to contractors a higher return than would be the case if the accounting conventions employed by industry were adopted. The Government therefore wishes to adopt a lower figure than 14 per cent when computing a return on capital employed based on the Government's accounting conventions. This view has not been accepted by industry and, as stated in paragraph 7, this matter is being referred for early decision to the Review Board for Government contracts. As a compromise pending this decision, and without prejudice to the principle involved, a return on capital employed of 13½ per cent, computed on the basis of the Government's accounting conventions, has been agreed for the purpose of pricing non-competitive Government contracts, and this memorandum is based on this figure.

Background to the new profit rates

3. The modified formula rates are based on the following points:—

- The 14 per cent yardstick is to apply to risk and non-risk Government work taken together.
- There must be an adequate differential between the rates for risk work and those for non-risk work: it follows that the rate for risk work must be above the target and that for non-risk work below it.
- The average cost of production: capital employed ratio for contractors engaged in profit formula work is 1½:1.
- Non-risk work is one-third of the total of profit formula work.
- The existing Government accounting conventions are to remain in force.

At the end of three years all these points will be reviewed by the Board. Points (c) and (e) are to be reviewed before then.

New profit formula

4. A new profit formula, expressed in the terms of the Government's accounting conventions, will be applied to non-competitive Government contracts let on or

after 26th February, 1968. The new rates set out below will be applied to risk contracts priced under the new Standard Conditions and to non-risk work provided it is carried out after that date on contracts for which no arrangement for profit had then been agreed.

Risk work :

11 per cent on capital employed plus 3 per cent on cost, providing (on the basis of the 1½:1 ratio referred to in paragraph 3(c)) an average rate of 15 per cent on capital employed.

Non-risk work :

8 per cent on capital employed plus up to 3 per cent on cost for efficiency, 1½ per cent being the intended average addition on cost. This provides (on the basis of the 1½:1 ratio referred to in paragraph 3(c)) an average return of 10 per cent on capital employed.

For risk work the full 3 per cent on cost will be allowed (see paragraph 13(d)), whereas for non-risk work it is intended that half the efficiency allowance of 3 per cent on cost should be allowed for average efficiency with up to the full 3 per cent being given for more than average efficiency and the allowance reduced below 1½ per cent or withheld only when circumstances so warrant.

In converting the foregoing formula rates to the percentages on costs which are to be applied to the costs of individual contracts the rate on capital employed should be converted by the application of each contractor's ratio of capital employed to cost of production, computed on the basis used hitherto. For the information of contractors, illustrations are to be given by the C.B.I. in the form shown in the Annex hereto.

The above rates replace the previous profit formula which was in force prior to 26th February, 1968:—

Risk work :

7½ per cent on capital employed plus up to 4 per cent on cost, with a ceiling on capital employed of 15 per cent.

Non-risk work :

7½ per cent on capital employed plus up to 2 per cent on cost, with a ceiling on capital employed of 10 per cent.

Contingencies

5. The Government and industry have agreed that under the new contract conditions providing for equality of information and post-costing it will still be necessary to include reasonable and justifiable contingency provisions in estimated costs for the purpose of fixing prices based on estimates. In order as far as possible to avoid both over-estimating and under-estimating contingency provisions, the following principles should be taken into account by both sides:—

- (a) Equality of information and post-costing do not lessen the need for contractors to include reasonable contingency provisions in their price estimates, but increase the need for these provisions to be separately identified and justified by reference to previous experience, the length of the contract, its complexity, or the degree of technical innovation involved.
- (b) It is intended that the prices negotiated should on average result in profits being earned at the rates set out in paragraph 4 above, and that higher rates should be achieved in contracts carried out with above average efficiency, but consistent over-provision for contingencies cannot be regarded as a legitimate means of attaining above average profits.
- (c) There may be occasions when a contingency provision openly declared and agreed at price fixing and accepted by reference either to the need for a similar provision in a comparable previous contract or to any of the reasons listed in (a) above turns out after post-costing to have been unnecessary in whole or in part. In such cases, the basic consideration is whether the nature of the contingency and the amount of the provision were fair and reasonable in the light of the information available to the two sides at price fixing.

- (d) If there is too much uncertainty to enable fair and reasonable prices to be fixed with appropriate contingency margins incorporated, the use of incentive contracts with profit sharing provisions should be considered.

Review

6. In order to review the effect of the new arrangements after they have been in operation for three years, it will be essential to review the evidence of industry's actual average earnings on Government non-competitive risk contracts and non-risk contracts so as to relate them to:—

- (i) the aim that the formula should achieve the average earnings of 14 per cent referred to above;
- (ii) the most recent appropriate evidence of the average earnings of British manufacturing industry.

For this purpose a Review Board for Government Contracts is to be established, comprising members nominated by the Government and by industry. Arrangements will be made for Government contractors to submit reports annually to the Board showing the average profits derived on non-competitive risk and non-risk Government contracts. At the end of three years the Board will conduct a comprehensive review of the formula and make recommendations to the Government. This review and subsequent reviews will consider both the target and the formula rates required to achieve it. The Board will not make available to the Government any of the contents of the reports received from individual firms, but the average results for all firms will be notified by the Board to the Government.

Interim Review

7. In addition to the comprehensive review mentioned above, which will be concerned with the level of profits actually achieved under the new formula, the Government and industry have agreed to accept the conclusions of the report which the Board will be required to make, not more than a year after it is set up, upon the following matters:—

- (i) The difference of view between the Government and industry which is referred to in paragraph 2, and what consequential adjustment, if any, is needed to be made to the formula set out in paragraph 4 so as to arrive at the agreed 14 per cent target. If the Board decides that a change in profit rates in the formula set out in paragraph 4 is required, then the profit rates will be adjusted prospectively either upwards or downwards for contracts placed after the date of the Board's decision and up to the date of the comprehensive review. Apart from any adjustments arising under this and the next three sub-paragraphs, no other adjustments to the profit rates will be made pending the full and comprehensive review referred to in paragraph 6 above.
- (ii) Whether a change is needed in the ratio of cost of production to capital employed of $1\frac{1}{2} : 1$ which has been previously agreed (see paragraph 3(c)).
- (iii) Whether certain costs which are at present not accepted as charges to Government contracts should in future be so accepted, and whether the allowances for depreciation included in costs should be based on the depreciation charges made by contractors in their accounts instead of by reference to Inland Revenue rates.
- (iv) Whether any, and if so what, change should be made in the treatment of (a) investment grants for the purposes of assessing the capital employed by Government contractors and (b) investment grants and other selective incentives for the purposes of overheads—if the discussions which have already been started between industry and the Treasury have not resolved this problem.

Excessive profits and unconscionable losses on risk contracts

8. Since it is not practicable to define a level at which profit automatically becomes excessive or loss unconscionable, owing to widely varying circumstances from case to case, it has been agreed that the Review Board should consider individual contracts referred to it by either side where the profit made comes to 27½ per cent or more on capital employed, or the loss on capital employed comes to 15 per cent or more. These figures do not of themselves involve a presumption of reimbursement. But in such cases, or in exceptional cases within these percentages where either side considers that the achievement of a fair and reasonable price was frustrated because the information on which it was based has proved to be materially inaccurate or incomplete, it will be for the Board to determine the level of any reimbursement by or to the contractor. All risk contracts will in future contain a clause binding both parties to accept the decision of the Board.

Equality of information and post-costing

9. Risk contracts placed on or after 26th February, 1968 will incorporate new contractual conditions giving the Government the right to equality of information and post-costing of individual contracts. Equality of information will be provided for in a new version of Standard Condition No. 43, "Condition No. 43—Price Fixing (revised July, 1968)", of Form CCC/Stores/1, and post-costing will be covered in a Standard Condition, "Condition No. 48—Availability of Information" to be inserted in Form CCC/Stores/1. It is intended that as a result of equality of information the Government and the contractor will be in the same position at the time the price is fixed. The Government will not normally expect more information from a contractor than is available to him up to the time of fixing the price. The Government must have access to information adequate for price fixing purposes. In general, this will be information from the contractor's normal accounting system. The Government will therefore limit any demand for further information to what can reasonably be shown to be necessary for price fixing purposes.

Use of Standard Conditions

10. S.C.43 1968 edition will be used where prices have not been agreed at the time the contract is made whenever it is the intention to negotiate an incentive price arrangement, including a fixed price, as soon as practicable.

S.C.48 may be used.

- (i) in conjunction with S.C.43 or
- (ii) in contracts on which fixed prices were agreed at the time the contract was made, except in the following circumstances:
 - (a) where the price had been determined as a result of competitive tendering;
 - (b) for purchase of proprietary articles for which a competitive general market price exists;
 - (c) in contracts of small value. The minimum of £25,000 for sub-contracts is an indication of this intention, but it is not possible to define small value for all contracts: it must depend on the circumstances of the contract.

This can only be a general statement and cannot cover all situations which vary with individual contracts. A combination of circumstances may occur in one contract requiring individual consideration. Since it will often be impossible to foresee future circumstances, it will be usual to include S.C.48 in all contracts except those specified at (a), (b) and (c) and also except in contracts containing S.C.54 or Form 6/77. In any case, the inclusion of the conditions in any particular contract remains a matter of negotiation between the parties.

Exercise of post-costing rights

11. The post-costing rights under S.C.48 will be exercised for the following purposes only :—

- (a) In pricing follow-on contracts, as an essential element in equality of information.
- (b) To enable departments to check the accuracy of their estimating procedures.
- (c) To provide the information for a selective scrutiny of the outcome of particular contracts so that reference may be made by either side to the Review Board.

It does not necessarily follow that the right to post-cost must always be exercised whenever this condition is included in the terms of a contract ; there should be selectivity, so that no undue burden is placed either on departments or on contractors.

Transitional arrangements for risk contracts

12. (a) Contracts placed but not priced before 26th February, 1968. Departments are authorised to use the new risk rates on contracts placed before 26th February, 1968 but unpriced at that date, provided that they are satisfied that the contractor has voluntarily given access to equality of information within the terms of the revised Standard Condition 43 in Form CCC/Stores/1.
- (b) Follow-on contracts placed on or after 26th February, 1968. If the contractor is prepared to volunteer post-costing information on the previous contract (to be used solely to establish the new price, not to judge the profit on the previous price), it would be possible to fix the price for the follow-on contract early. If the contractor is not prepared to concede voluntary post-costing information, departments may not find it possible to fix prices early and may have to issue an " Instruction to Proceed " incorporating the revised S.C.43.

General provisions

13. (a) Both the Government and industry attach considerable importance to the need to fix prices as early as practicable. Where there is unreasonable delay in fixing prices, there will in the last resort be a right of appeal to Ministers by contractors.
- (b) In all cases where pricing is possible in advance of work, fixed prices (or incentive target price arrangements) should be used. In other cases fixed or incentive target prices should be negotiated as soon as practicable.
- (c) Cost plus arrangements with the non-risk rates, which have disadvantages in lack of incentive to both sides, should be reserved for those contracts where there is no alternative. The non-risk rate is applicable only to cost plus contracts and for negotiating the fee in cost plus fixed fee for profit. Cost plus contracts subject to a maximum price are risk contracts.
- (d) It is the intention to identify risk contracts at the time when instructions are given to proceed and, having made the initial decision to price on estimates, not to vary the allowance for risk because of delays in agreeing prices.

Effective date of future adjustments to the profit formula

14. The Government and industry have agreed that if adjustments of the profit formula rates upwards or downwards are required after future reviews, including the Interim Review, these adjustments should be applied in the same way to contracts which are not complete in the sense that the price has not been fixed. Adjustments would therefore apply to :

- (a) risk contracts where no price arrangement has been agreed on the date the adjustments take effect ;
- (b) non-risk work carried out after that date for which no arrangement for profit has been agreed by that date.

ANNEX TO APPENDIX B

APPLICATION OF THE NEW AGREED PROFIT RATES BASED ON THE GOVERNMENT'S ACCOUNTING CONVENTIONS

Set out below are the average returns on capital employed computed on the Government's formula that will be achieved by averagely efficient contractors with different ratios of cost of production to capital employed on the basis of two-thirds risk work and one-third non-risk. Also set out are the percentage profit margins that will have to be applied to costs to achieve these returns. The percentages set out in column 3 will not be altered even though the actual mix of risk work and non-risk work in a contractor's business differs from the agreed basis of two-thirds and one-third.

1		2	3
<i>Ratio of cost of production to capital employed</i>		<i>Return on capital employed</i>	<i>Required profit additions to cost</i>
0·9 : 1			
Risk	$11+2\cdot7$ $\frac{2}{3}$ of $13\cdot7$ = $9\cdot13$	= $13\cdot7\%$	$15\cdot2\%$
Non-risk	$8+1\cdot35$ $\frac{1}{3}$ of $9\cdot35$ = $3\cdot12$	= $9\cdot35\%$	$10\cdot4\%$
	Overall return <u><u>12·25%</u></u>		
1 : 1			
Risk	$11+3$ $\frac{2}{3}$ of 14 = $9\cdot33$	= 14%	14%
Non-risk	$8+1\cdot5$ $\frac{1}{3}$ of $9\cdot5$ = $3\cdot17$	= $9\cdot5\%$	$9\cdot5\%$
	Overall return <u><u>12·5%</u></u>		
1½ : 1			
Risk	$11+4$ $\frac{2}{3}$ of 15 = $10\cdot0$	= 15%	$11\cdot2\%$
Non-risk	$8+2$ $\frac{1}{3}$ of 10 = $3\cdot33$	= 10%	$7\cdot5\%$
	Overall return <u><u>13·33%</u></u>		
1·5 : 1			
Risk	$11+4\cdot5$ $\frac{2}{3}$ of $15\cdot5$ = $10\cdot33$	= $15\cdot5\%$	$10\cdot3\%$
Non-risk	$8+2\cdot25$ $\frac{1}{3}$ of $10\cdot25$ = $3\cdot42$	= $10\cdot25\%$	$6\cdot8\%$
	Overall return <u><u>13·75%</u></u>		
2 : 1			
Risk	$11+6$ $\frac{2}{3}$ of 17 = $11\cdot33$	= 17%	$8\cdot5\%$
Non-risk	$8+3$ $\frac{1}{3}$ of 11 = $3\cdot67$	= 11%	$5\cdot5\%$
	Overall return <u><u>15·0%</u></u>		

Note: The percentages shown in column 3 of the illustration above have been included to one decimal place only for convenience.

APPENDIX C

EXTRACT FROM A LETTER DATED 22nd JUNE, 1970 FROM H.M. TREASURY, EXTENDING THE INTERIM REVIEW

1. Thank you for your letter of 27th May, copied to Mr. Gray of the Confederation of British Industry, about the Review Board's consideration of marketing expenses and research and development expenditure in overheads as part of its Interim Review of the new arrangements for non-competitive Government contracts.
2. On marketing expenses, whilst it does not consider the amounts allowed in overheads in total for market expenses to have been unreasonable, I understand that the Board intends to say in its report that it proposes to examine figures in more detail with individual contractors, with a view to developing clear principles for the treatment of marketing expenses in overheads attributable to non-competitive contracts. This would require an extension of the one-year period fixed under the Memorandum of Agreement for completion of the Interim Review. In your letter you were good enough to add that you propose to consult fully with both the Government and industry before making any decisions.
3. On the treatment of private venture research and development expenditure in overheads, I note that the industry representatives appear ready to accept the proposal for discussion in the Government's submission that purchasing Departments and the industries concerned should discuss further the procedures for examining and classifying such expenditure outlined in paragraphs 5.6.7—5.6.10 of the Report of the Joint Working Party on Overhead Costs. They have also suggested that it would be helpful for either of the parties to these discussions to be able to refer to the Board for a decision on any point of difference arising out of the Working Party's principles. I am sure, also, that the discussions will be more effective if, rather than being on an industry-by-industry basis, they are between representatives of the purchasing Departments on the one hand and an industry team on the other.
4. The Government side are quite agreeable to the Interim Review period being extended for a period of up to one year, i.e. to 1st August, 1971, for further consideration of marketing costs and research expenditure along the lines suggested.

APPENDIX D

A LIST OF THE 14 COMPANIES AND 13 TRADE ASSOCIATIONS WHO HAVE SUBMITTED EVIDENCE

Babcock & Wilcox, Limited.
Clarke Chapman & Co. Ltd.
Dowty Group Limited.
Fairey Surveys Ltd.
Fulmer Research Institute Limited.
Graseby Instruments Ltd.
Hartley Electromotives Limited.
Link-Miles Limited.
F. G. Miles Engineering Ltd.
The Plessey Company Limited.
Tom M. Scotney Limited.
Temperature Limited.
G. & J. Weir Limited.
Westinghouse Brake and Signal Co. Ltd.

The Association of the British Pharmaceutical Industry.
The Association of Consulting Scientists.
Association of Specialised Film Producers.
The British Electrical and Allied Manufacturers' Association Limited
British Mechanical Engineering Confederation Limited.
The British Photographic Manufacturers Association Ltd.
Chemical Industries Association Limited.
Electronic Engineering Association.
The Federation of Manufacturers of Construction Equipment and Cranes.
The Society of British Aerospace Companies, Ltd.
The Society of Motor Manufacturers and Traders Limited.
Shipbuilders and Repairers National Association.
Telecommunication Engineering & Manufacturing Association Limited.

**EXTRACT FROM THE REPORT OF THE JOINT WORKING PARTY
ON OVERHEAD COSTS : PRIVATE VENTURE RESEARCH AND
DEVELOPMENT EXPENDITURE**

The Working Party's Approach

5.6.7. The Working Party's approach is to outline the nature of the problem and indicate the principles on which it might be resolved. Within these agreed general guidelines discussion can then be pursued, preferably on an industry by industry basis, since, although the basic problems are common to all research and development effort, the proportion of that effort which is specifically identifiable to products will vary according to the technology involved and its rate of change.

5.6.8. Despite the complexities of dealing with R. & D. arising from its technical characteristics, the aim should be to resolve the problem in terms of costing and accounting principles and methods. Accordingly the costing and accounting approach should be to:

- (a) Classify the expenditure to facilitate its identification with appropriate cost centres and/or products, or to customers orders as the case may be.
- (b) Identify the expenditure so classified having regard to the technical characteristics and the purpose of the work undertaken, with the cost centres, products or customer projects which have been selected as appropriate, and allocate or apportion such expenditure thereto in accordance with accepted costing and accounting principles of allocation and apportionment.
- (c) Determine the method of recovering the expenditure so allotted, directly or indirectly as the case may be, and the period of time or the product volume over which the expenditure is to be recovered.
- (d) Ensure throughout the costing process that the accounting principles are consistently applied.

Expenditure Classification

5.6.9. The classification of expenditure referred to in 5.6.8.(a) should distinguish between—

(a) Customer Sponsored Work.

(b) Contractor Sponsored Work—

 Basic Research.

 Applied Research.

 Product Development.

 Product Support and Servicing.

In order to ensure consistency in the treatment of the various categories of expenditure, defined cut-off points as between basic and applied research and product development may be necessary. Moreover, the special characteristics of Research and Development have also to be considered as matters of accounting principle.

Proposed Principles

5.6.10. A contractor's normal method of recovering Research and Development expenditure should preferably be followed for Government pricing purposes, provided it is based on sound costing practices. The methods of recovery adopted may vary as between individual contractors according to the nature of the products. Costs may be expressed as a cost per unit of production or be absorbed in the overhead of the cost centres through which the products pass in the course of manufacture. In some cases it may be appropriate for the costs of research to be dealt with as overhead but for Product Development to be recovered as a cost per unit of production. However, the general principles of recovery proposed by the Joint Working Party are as follows:

- (1) Customer sponsored Research and Development work, both Government and Commercial, where work is directed at a specific product or towards the acquisition of knowledge in a particular field for the benefit of that customer.

Expenditure should be treated as a direct charge to the product or contract concerned. If a subsequent customer appears for work undertaken in this category the original sponsor would normally be entitled to a fee or royalty payment.

- (2) Contractor sponsored Research and Development work exclusively for his own products.

The expenditure should be treated as directly attributable to the products concerned. Where such products are of a class which is used generally within other products, e.g. printed circuits or electronic components built into equipment assemblies, it may be desirable to absorb the R. and D. costs in the overhead attributable to such components and thus to recover the costs on a proportional usage basis.

- (3) Contractor sponsored Research work of a general nature, including basic research and applied research in developing techniques for general application within broad product fields, from which may ultimately emerge new products, improved processes, etc., but only after further work falling under (1) and (2).

This category may be further sub-divided as follows:

- (a) Contractor sponsored basic research.

This should be treated as generally attributable.

- (b) Contractor sponsored applied research.

This should be treated as attributable to all work within related product areas, or as an overhead applied to development work in these same product areas. In this context, a product area may be very broadly interpreted. For example, in the case of an airframe manufacturer it could well cover all his production, thus becoming generally attributable as in 3(a) above but, in other cases, broad distinctions might be drawn between different types of products.

- (c) Contractor sponsored applied research directed at improved techniques or processes with application in many product fields.

This should be regarded as attributable over all product groups which might benefit from the application of such techniques.

- (4) Contractor sponsored product exploratory work which, had it proved successful, would have benefited the development or productive effort of work emergent from both categories (1) and (2). (For example, work on the development of a civil aircraft to fulfil a military role.)

At the time this expenditure is incurred it will not be known whether or not a project will prove to be abortive. It is appropriate therefore that research expenditure should fall naturally, as and when incurred, into the categories of basic and applied research as in 3(a), (b) and (c) above and should be accorded similar treatment. Contractor sponsored Development work, if abandoned as abortive should be treated as attributable to all work within the product area to which it relates, or as an overhead applied to continuing development work in the same product area.

- (5) Contractor sponsored work of a product servicing or support nature.

This should, when practicable, be attributable to the product or product group concerned. When, however, as in the capital goods industry, the nature of the product is such that there is a continuing commitment to update and service it long after production may have ceased, and where

it is impracticable to recover the cost on a specific product basis during production (due to the difficulties of estimation of the cost and the quantity of the product over which to spread the expenditure), a more general basis of recovery may be desirable. Given consistency of treatment of products in the same field, and a defined cut-off point at which development effort is no longer to be treated as specific to a product, the treatment of the cost of future effort as of general product incidence would appear to be desirable. It must be emphasised, however, that there must be equality of treatment between Government and other customers, with particular reference to practices relating to warranties and servicing contracts, so that work carried out under warranty, or services specific contracts, would not be treated as generally attributable.

APPENDIX F

GOVERNMENT SUBMISSION—6TH JANUARY, 1970

REVIEW BOARD : INTERIM REVIEW

NON-COMPETITIVE GOVERNMENT CONTRACTS : ASSESSMENT OF OVERHEAD COSTS AND CAPITAL EMPLOYED

1. The Chairman of the Review Board for Government Contracts informed the Treasury on 23rd September, 1969, that the Board had decided that, of the subjects to be covered in the Interim Review, the ones requiring most immediate consideration were the Government accounting conventions, insofar as they affect attributable costs, depreciation charges and the treatment of investment grants and other selective incentives. He went on to invite an official submission on the questions outlined in paragraph 2(b) and (c) of the Annex to the Memorandum of Agreement covering the establishment and terms of reference of the Board. These paragraphs invite the Board to consider the following questions:—

- (b) whether certain costs which are at present not accepted as charges to Government contracts should in future be so accepted, and whether the allowances for depreciation included in costs should be based on the charges made by contractors in their accounts instead of by reference to Inland Revenue rates ;
 - (c) whether any, and if so what, change should be made in the treatment of (i) investment grants for the purposes of assessing the capital employed by Government contractors and (ii) investment grants and other selective incentives for the purposes of overheads.
2. These questions concern the practices or conventions followed by Government Departments when determining overhead expenses and capital employed for the purpose of pricing non-competitive contracts. It is important also to bear in mind that certain items, for example depreciation and "private venture" research and development expenditure affect both these aspects of pricing, so that both need to be considered together.
3. In general it may be said that there are two broad principles underlying the practices or conventions followed by purchasing Departments. First, there is the need to identify all costs, either direct or overheads, attributable or appropriate to the work to be carried out. Secondly, there is the desirability of ensuring, so far as possible, consistency of treatment and of avoiding what might otherwise appear to be arbitrary decisions. This is clearly all the more necessary because the calculation of profit rates depends upon the assessment of a contractor's capital employed. The application of these principles frequently necessitates adjustments to the figures resulting from the accounting methods used by individual firms, not because they are improper but because of the inevitable lack of uniformity amongst the methods used by individual contractors, and also because of certain special considerations which arise in relation to non-competitive Government work, as explained later in this submission.
4. The rest of this submission summarises the practices or conventions normally followed by purchasing Departments when assessing overhead costs and capital employed for the purpose of pricing non-competitive Government contracts, makes such general comments as seem necessary to explain them, and then comments in more detail on the specific points mentioned in the paragraphs from the Annex to the Memorandum of Agreement quoted above, insofar as they have not already been adequately covered.

Conventions normally followed by Purchasing Departments

Overhead Costs attributable to Government work

5. In assessing contractors' claims for overhead costs on non-competitive Government work current practice is broadly :—

A. to accept in overheads :—

- (1) costs specifically identifiable to Government work, and
- (2) costs which apply generally to both Government and non-Government work adjusted if necessary to correct any disproportionate incidence on such work.

B. to exclude from overheads :—

- (1) costs identifiable to non-Government work alone, and
- (2) certain costs which for taxation purposes are treated as "capital" or not allowable, or which are not regarded as incident in the same periods as allowable for taxation purposes.

6. Accordingly, adjustments may be made to contractors' claims for overheads as follows :—

A. Items which are normally totally excluded :—

- (1) Generally, any expenditure of a capital nature and other items not allowed by the Inland Revenue for tax purposes, including general reserves.
- (2) The cost of raising and servicing capital, including short-term financing, as the capital so raised is serviced out of profit.
- (3) Pooling levies or other arrangements of a similar nature.
- (4) Bad debts and any reserve therefor, as these do not arise on Government contracts.
- (5) Discounts allowed on sales, which are treated as abatements of selling prices.
- (6) Subscriptions and donations, except for reasonable contributions to institutions from which benefits accrue to the contractor and/or his employees. Payments to bodies of a political nature are not admissible.
- (7) Employees' profit-sharing schemes.
- (8) Insurance related to civil work risks for which cover is not required in the case of Government work.
- (9) Salesmen's and agents' commissions. These are regarded as charges recoverable against the particular civil sales that result from these expenses.
- (10) Outward carriage (of finished products). Most Government contracts are priced ex-works: in other cases the cost of delivery would be directly charged.
- (11) Notional transactions : e.g. rental charge for property owned.
- (12) Unnecessary, extravagant or wasteful outlays.
- (13) Loss of profits insurance (profits element only).
- (14) Royalties and licence fees : but these may in certain circumstances be admitted as an item of direct cost and separately identified.
- (15) Depreciation : (see paragraph 8A).

B. Items which may be partially excluded :—

- (1) Entertainment expenses.
- (2) Advertising of a "goodwill" nature.

- (3) Compensation payments of an abnormal nature. If substantial, yet admissible, some forward spread may be necessary.
- (4) Lump sum additions to pension schemes: generally allowed on the Inland Revenue basis (but spread over a number of years if substantial).
- (5) Selling and marketing costs (see paragraph 8B below).
- (6) Research and Development (see paragraph 8C).
- (7) Redundancy payments in excess of the rates laid down by Statute.
- (8) Expenditure relating to assets not employed or demonstrably underemployed.

C. Items brought to account as reducing overhead costs :—

- (1) Credits or refund generally, both in relation to overhead items and also to direct cost items where the credit cannot be identified to a particular contract.
- (2) Industrial Training Grants.
- (3) Regional Employment Premiums.
- (4) Selective Employment Tax Refunds and Premiums.

7. It will be appreciated that it is not possible to produce an exhaustive list covering all the adjustments which may from time to time be required in computing overheads on non-competitive Government contracts. Nor is it possible to lay down absolutely fixed rules, given the varying circumstances prevailing within different organisations.

8. As three of the items referred to in paragraph 6 can relate to overhead expenses of considerable magnitude further comment on the current Government treatment of these items is given below :—

A. *Depreciation.* In general the practice of purchasing Departments is to substitute for the contractor's own depreciation charge in his overhead claim the allowances on fixed assets as computed for Inland Revenue purposes. The reason is to provide some degree of uniformity of treatment between Government contractors and to avoid arbitrary decisions. It is recognised that absolute uniformity is not practicable; for example, companies may elect for Inland Revenue purposes to be on a renewals basis instead of a capital allowances basis. Furthermore, capital allowances have sometimes been varied to give incentives for capital investment by industry; for example, scientific research allowances and "free" depreciation, the acceptance of which in overheads for one year might result in a charge for depreciation disproportionate to the contribution made to production by the assets in question. In such cases Departments normally seek to spread the allowances more evenly over a period of years.

B. *Selling and Marketing Costs.* Selling and marketing costs include market research, sales promotion, general prestige and product publicity, exhibitions and displays, sales, technical and liaison staff and associated administration costs. Departments require selling and marketing costs to be separately identified, so far as possible, in a contractor's overhead claim. The onus of showing that exclusion of such costs would be unreasonable is placed on the supplier, since the Government is not "persuaded" to buy by normal commercial methods of selling, and no marketing effort is involved on the part of the contractor. Where selling expenses can be separately identified to products rather than charged pro-rata over the contractor's full range of production, this is done in order to facilitate consideration of their acceptability for inclusion in

overheads attributable to Government supplies. Departments take account of efforts by contractors to obtain commercial (non-Government) business if this seems likely to reduce the incidence of general overhead expenditure on Government supplies by enabling this expenditure to be spread over a larger total volume of business ; they also take account of the reverse benefit to non-Government business that accrues from Government contracts.

A particular problem arises where marketing expenses are incurred in periods prior to production, or where such expenses are too large to be recovered against the production of the period in which they are incurred. Industry normally adopts the practice in such circumstances of charging the selling expenses against current profits and of recovering the costs as far as possible in the prices of current sales. The overhead claim may therefore include selling and marketing costs which relate to products not currently in full production and not necessarily contemplated as Government purchases, the benefit of which will be recovered by the contractor in selling prices in the future. The inclusion of such overheads in the price for current Government purchases is only acceptable if it can be shown that the expenditure relates to the group of products Government is buying, and that future Government purchases will benefit from the expenditure.

C. "*Private venture*" research and development. This can conveniently be considered under three headings.

- (1) *Basic Research*, which is directed toward the increase of knowledge, its primary aim being a fuller knowledge or understanding of the subject under study rather than any particular practical application thereof.
- (2) *Applied Research*, which normally follows basic research ; attempts to determine and expand the potentialities of new scientific discoveries or improvements in technology, materials, processes, methods, devices and techniques ; and attempts to advance the state of the art.
- (3) *Product Development*, being the systematic use of scientific knowledge directed toward the production of, or improvements in, useful products to meet specific performance requirements, but exclusive of manufacturing and production engineering.

Purchasing Departments generally accept in overheads as attributable costs all reasonable "*private venture*" *research* expenditure, as defined in (1) above. On the other hand, "*private venture*" *development* expenditure incurred for exclusively commercial projects, i.e. for which the Government is not a customer, is not accepted for inclusion in overheads on Government non-competitive contracts. Where Government buys proprietary articles, however, development costs relating to these products are acceptable in overheads, provided that the costs are reasonable for the industry and are allocated as overheads over all work of the contractor within the relevant product group. The identifiable areas of, on the one hand, basic research and, on the other, specific product development can be satisfactorily dealt with in accordance with these principles. Between these two areas, however, there is often a large "grey" area. Dealing with this often involves, *inter alia*, consideration of the extent and nature of direct Government sponsorship of a contractor's research and development projects. When a contractor receives Government-sponsored research and development contracts the additional "know-how" which he thereby acquires is a relevant factor, as is also the fact that Government bears the full cost of any unsuccessful projects.

Capital Employed

9. It is unusual to find circumstances in which capital employed can be specifically related to a particular contract or to Government work in total. The usual practice, therefore, is to compute capital employed for a contractor's business as a whole, or possibly for a section of a contractor's business to which the Government interest is confined and for which separate figures are available.

10. A contractor's total capital employed is taken as the average of his total net assets as shown in his Balance Sheets at the opening and closing of the period under review, adjusted for the following where relevant:—

A. Assets

(1) Exclude—

- (a) *Goodwill* (an investment in aid of future profits) and *preliminary expenses*.
- (b) Adverse (debit) balance on *profit and loss account*.
- (c) *Investments* in shares and securities being capital not employed in the business.
- (d) *Shares held in and permanent loans to subsidiary companies* (trading balances are included in capital employed) being capital not employed in the business of the parent Company.
- (e) *Cash* (or any other assets) demonstrably *surplus to requirements*.
- (f) Land and buildings *not in occupation* and plant and machinery demonstrably *not in use* (and also a proportion of such assets as are demonstrably under employed).
- (g) Any additions to Balance Sheet values of assets arising from revaluation.

2. Other adjustments (these may result in either an addition to or a deduction from Balance-Sheet figures, according to the circumstances).

- (a) Value of *plant and building* to written-down value as agreed with the Inland Revenue for tax purposes for the relevant year (but subject to adjustment concerning Scientific Research Capital Allowances when the formula has been applied restricting write-off to less than 100 per cent per annum). The written-down value of plant will be based on cost reduced by investment grants received.
- (b) *Value of work-in-progress* may be amended to restore the amount of general reserves deducted therefrom, or to include a realistic figure for overhead expenses. If an increase is claimed in respect of overhead expenses, an auditor's certificate may be called for to support this. Reserves for specific anticipated losses will not be added back in the computation of capital employed.
- (c) If a company has not already done so in its Balance Sheets, *cash on account of work-in-progress* is deducted from the gross work-in-progress figure.
- (d) *Patents and Trade Marks* are normally excluded. To the extent, however, that a company can demonstrate that patents and trade marks are "live" and contribute to its earnings, some value may be included in capital employed, although not shown in the company's Balance Sheet.
- (e) *Development expenditure*—mainly on Private Venture work—if not already included in Balance-Sheet figures may be included in capital employed (even though it may have been written

off by the company) provided orders have been received or are likely to be received for the product under development, and there is a reasonable prospect, therefore, of recovery of development costs in the prices of those orders. This will not apply, of course, where the expenditure is included in overheads.

- (f) *Customers' deposits*—these deposits are usually paid over at the time the order is placed, and are therefore in advance of any production. They are deducted as cash on account of work-in-progress but any balance in excess of the total value of work-in-progress at any time is normally not deducted in the capital employed computation. All prepayments by H.M.G. are deducted.
- (g) *Tax Reserve Certificates* are included as capital employed, up to, but not exceeding, an estimate of two years' outstanding liability for tax.
- (h) Where *semi-capital items* are written off to overheads, some spread over several years may be called for. Any amount not written off at a Balance-Sheet date will be included as an asset in capital employed.
- (i) *General reserves* deducted against debtors will usually be added back to capital employed, but specific reserves will not. Occasionally Balance-Sheet figures of debtors will be raised for increases becoming known after the Balance-Sheet date, due to settlement of prices previously included in provisional figures.

B. Creditors and Other General Adjustments

- (a) All *loans* which are interest-bearing are admissible as capital employed—i.e. not deducted from assets. On occasion a non-interest-bearing loan is encountered, and it is a matter of judgment as to whether or not this is deductible from assets.
- (b) Any *fixed-interest loans* such as debentures and specific bank (or other) loans are usually averaged on the two Balance-Sheet figures, unless any new items have been introduced during the year when the date of such introduction is used to give a more precise average figure for that year. Short-term fluctuating borrowed monies such as bank overdrafts may be averaged by deducting the Balance-Sheet figures as ordinary liabilities and substituting as an addition to capital employed the value of the capitalised interest paid during the year under review.
- (c) *Taxation* is treated as a creditor only to the extent of the amount due at the beginning of the year under review. Any provisions or reserves in excess of this figure are not deducted from assets in computing capital employed.
- (d) *Launching aid* is usually treated as a creditor in computing capital employed, and as such is deducted from work-in-progress as the equivalent of cash on account of work done. Varying circumstances may however call for judgment as to whether the whole amount should be so deducted.
- (e) *Dividends declared* are treated as creditors in computing capital employed, but proposed dividends are not so treated.

C. Government Capital Assistance

In arriving at capital employed for Government profit formula purposes there is added to the contractor's figures *one-eighth* of the value of Government-owned assets (usually plant, machinery or buildings) provided on loan to the company under Capital Assistance Agreement(s).

11. Although numerous adjustments are made to Balance-Sheet figures in computing capital employed for the purpose of profit negotiation on Government contracts, it has to be realised that there is no absolute and final figure for capital employed which can be computed according to fixed and inviolable rules. Just as some items in a Balance-Sheet are a matter of judgment and opinion as to the amount to be included, so it is with capital employed. Where, in such cases, there are no absolute rules, some judgment is called for.

12. The computation of capital employed on the basis of the conventions summarised in the previous paragraphs generally results in a higher figure for capital employed than is normally shown in, or derived from, published Balance Sheets. In the case of the aerospace industry this arises largely from the writing back of large amounts of recoverable research and development expenditure, and, to a lesser extent from the averaging of loan and bank overdrafts, the treatment of customers' deposits, taxation and work-in-progress. In the case of other industries these latter factors are the main ones.

Comments on Specific Questions

13. Paragraph 2(b) of the Annex to the Memorandum of Agreement quoted in this Appendix raises the question whether the allowances for depreciation included in costs should be based on the charges made by contractors in their accounts instead of by reference to Inland Revenue rates.

14. This question, together with other questions on attributable costs, was examined by a joint Government/Industry Working Party on overhead costs set up in 1966. The Report of this Working Party, dated September, 1968, recognised that the administrative advantages to purchasing Departments and to contractors of adopting companies' normal bases of dealing with depreciation would be considerable. It pointed out that certain transitional problems would arise if contractors' methods were adopted, but considered that these would be surmountable.

15. H.M.G. recognises the administrative advantages of adopting a contractor's methods of amortising the *original* costs of fixed assets (net of investment or other grants—see below), and would be prepared to do so provided that these methods are consistent and result in a fair and reasonable charge for depreciation to be included in overheads. As the Working Party's Report recognised there would be certain transitional problems.

16. The Working Party's Report also noted that there has been an increasing tendency over recent years, as shown in companies' published accounts, for provision to be made for the eventual increased costs of replacing fixed assets. The acceptance of replacement cost provisions in overheads on non-competitive Government contracts, however, would necessitate agreement on a basis for specific charges related to acceptable indices. The representatives of the purchasing Departments saw considerable difficulties in this, given the widely varying practices at present adopted by different companies and the lack of any clear guidance from the professional accountancy bodies.

17. Apart from the considerable practical difficulties involved, general acceptance of replacement cost provisions would also have implications going far beyond the immediate effect on non-competitive Government contracts. It could start a chain reaction, and to the extent that prices were increased the effect would be to anticipate and compound the certainty of continuing inflation in the economy generally.

18. Paragraph 2(c) of the Annex to the Memorandum of Agreement quoted in this Appendix raises the questions whether any, and if so what, charges should be made in the treatment of (i) investment grants for the purposes of assessing the capital employed by Government contractors and (ii) investment grants and other selective incentives for the purposes of overheads.

19. So far as investment grants are concerned, present Departmental practice is to admit to overhead charges for inclusion in contract prices only the amortisation of the net cost of assets as reduced by the grants. In assessing capital employed for the purposes of non-competitive Government contracts the value of investment grants is similarly deducted. This is in accordance with the treatment of investment grants for Inland Revenue purposes, and is in line with the recommendations of The Institute of Chartered Accountants in England and Wales on the treatment of investment grants in company accounts.

20. So far as the treatment of "other selective incentives" is concerned, Selective Employment Tax Premium (S.E.P.) is now payable only in Development Areas, and under Legislation currently before Parliament will be withdrawn altogether as from April, 1970. For the purpose of the Interim Review, therefore, the Regional Employment Premium (R.E.P.) appears to be the only "selective incentive" requiring comment.

21. The main intention behind the introduction of R.E.P. was to make firms in the Development Areas more competitive by reducing their costs. In line with this, H.M.G. has taken the view that in the case of non-competitive Government contracts this reduction in costs should be reflected by crediting the premiums to overheads.

22. The profit element included in the price negotiated for non-competitive Government contracts is intended to remunerate the contractor's own capital employed in the execution of the work. The treatment of investment grants and R.E.P. described above is in accordance with this objective.



Review Board for Government Contracts

REPORT ON THE INTERIM REVIEW

LONDON
HER MAJESTY'S STATIONERY OFFICE
1970

REVIEW BOARD FOR GOVERNMENT CONTRACTS

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